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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1991

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

AND

THE CONDITION OF THE BANKING INDUSTRY AND ITS BROADER ECONOMIC IMPLICATIONS

FEBRUARY 20 AND 21, 1991

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1991

WEDNESDAY, FEBRUARY 20, 1991

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 10:03 a.m., in room SD-538 of the Senate Dirksen Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance this morning. We're pleased to welcome, in particularly the Chairman of the Federal Reserve Board, Alan Greenspan, before the committee today. He is here to testify on the Fed's semiannual report on monetary policy which was released this morning.

In analyzing that report and looking at the economic situation generally, there are a number of very difficult and important problems that face us today and affect monetary policy. Certainly, the economy has gone into a tailspin since the last report that was made here under these same circumstances. We're now in the midst of a recession in which such indicators as housing starts and auto sales have already fallen to levels that approximate those of the 1982 recession. And this very morning, data has come out that show that housing starts have fallen another 13 percent to a rate a little better than half of that of a year ago. Commercial real estate markets are in very tough circumstances, as was testified to by members of the RTC just within the last 2 weeks and, of course, Chairman Greenspan was here as part of that Board.

Now in response, the Fed has cut bank reserve requirements and has lowered its key interest rate target by 2 percentage points since last summer. But the decline in interest rates the banks actually charge their customers has been much smaller. And in fact, banks' willingness to lend even at those rates has diminished because of capital and other regulatory concerns affecting the banking system.

How one measures this credit crunch and how we go about adjusting the monetary policy to account for it are matters that we have discussed before. This committee appreciates the difficulty of understanding precisely what may be in that mix of circumstance that the Fed is endeavoring to evaluate and respond to.

In addition to that, of course there are the uncertainties attaching to the war in the Persian Gulf and how that may be affecting spending decisions by households and companies.

I think this recession is also unique with regard to the enormous debt burdens that are carried by consumers and businesses. Many have speculated that we should expect an unusual number of bankruptcies in this recession and, in fact, there is news this morning in The Washington Post of just the bankruptcy patterns here in the metropolitan area and the fact that they're up quite substantially, as they are in a number of areas across the country.

This committee is also very much concerned about pressures that have accumulated within the banking system and the fact that the pressures there clearly appear to be contributing to the credit crunch, and that, in turn, makes the economy less able to respond to the recession even when interest rates are lowered.

Now, with respect to the issue of inflation, we have not heard a lot of talk about inflation because the focus has been on other problems, particularly the recession and the war. But it's important to note that inflation last year was the highest that we have seen in 8 years, even abstracting from the recent rise in energy prices.

This morning's data indicates that the core CPI Consumer Price Index, excluding food and energy which tend to be more volatile, was up 8/10ths of 1 percent. Now that's a single month's data and you can't hang your hat entirely on 1 month's data. But it does seem to indicate, based on the inflationary pressure that we've already seen for last year, that there are pressures there that are a matter of concern.

Finally, there are two things most on my mind that I hope the Chairman will respond to today. First, in light of these kinds of factors and elements that are in the economic puzzle at the present time, how much monetary policy latitude does the Fed have? How much latitude is there to change interest rates to really be able to interdict the path of the economy in a material way?

Said another way—how much can we expect the Fed by itself, through adjustments in monetary policy, to somehow create a wonderfully better outcome in the economy that we would all like to see?

The second thing that I hope you'll comment on directly is that while you have lowered the Federal funds rate and attempted in other ways to ease credit for banks, the prime rate has really not come down very much. I think it ought to have come down more, but that's a personal opinion.

The prime rate has fallen only to 9 percent. I think we need to understand better why it is that we're not seeing a corresponding reduction in interest rates offered by banks in response to lower borrowing rates that the Fed has provided to the banking system, presumably to help bring consumer rates down to a lower level that could help lift the economy.

So with that, let me yield to my colleague, Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you very much, Mr. Chairman.

The economic problems besetting our Nation's economy today provide yet another overwhelming argument for congressional action to update the legislative framework within which American financial institutions must operate.

Hearings conducted by this committee throughout all of the 1980's provided irrefutable evidence that we need to revise our banking laws if American institutions and American markets are to remain competitive in the evolving international market place for financial services.

The crisis in the savings and loan industry shows us the horrendous potential cost to taxpayers of failure to protect the health of a very important segment of the financial services industry.

Today, most economists expect the current economic downturn or recession to be mild and short-lived. However, the most frequently mentioned caveat to this economic forecast is that such an optimistic future could be undermined if our financial institutions proved to be too weak to finance a healthy economic recovery and expansion.

Thus, failure by Congress to act to strengthen the financial services sector will not only threaten our international competitiveness and threaten to impose huge costs on taxpayers; it can also undermine the whole growth outlook for the economy.

To its credit, the administration has proposed an ambitious plan for revamping our financial structure laws in a way that would enhance the ability of financial institutions to weather periods of regional economic stress and enhance the ability of financial institutions to raise needed capital as well as, enhance competitiveness of financial institutions in a rapidly changing market place.

Along with examining the course of monetary policy, I hope today's hearing can shed some additional light on the linkages between the health of the financial services industry and the health of the overall economy.

Now I realize, Mr. Chairman—both Mr. Chairmens—that you've had to endure my comments along this line for the last decade and a half. But it's interesting. Fifteen years ago when I started talking about the need to modernize and be more competitive, I used to say that it would happen if we didn't set policy. It would happen anyway, and it has. Overwhelmingly. It's happened in the courts. It's happened in the State legislatures, the regional compacts, and all of the different experiments that they've been involved in. And it's happened in the regulatory agencies.

Interstate banking has been here for years. We haven't legalized it, but with the merger of troubled institutions across State lines, and the technology of computers with cash machines and all of that, it exists.

The point is that it's long past due the time for Congress to act on this problem, rather than in a piecemeal way with band-aids and with turniquettes and rushing here and there to put the finger in the dike.

I think it's way past time that we deal with comprehensive banking legislation and deposit insurance reform.

If the time isn't now, I don't know when it will be. So I would hope, Mr. Chairman, that, again, along with talking about monetary policy and the economy, you might make some comments as to

your feelings about remodeling, modernizing the financial structure in this country and what impact it would have on the economy, particularly in light of all the talk about the credit crunch and other issues that are talked about daily in the press.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Dixon?

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I'm pleased to be here this morning as the Senate Banking Committee hears the Federal Reserve's first monetary policy report for 1991. I certainly look forward to the testimony of Chairman Greenspan.

As we review the Fed's analysis of our country's recent and prospective economic performance, I want to express my concern, Mr. Chairman, about the so-called credit crunch which you alluded to.

I understand that a recent Fed survey of banks showed a tightening of bank lending standards and terms in recent months. And I want to hear Mr. Greenspan's views on whether financial institutions are indeed reluctant to lend to creditworthy businesses.

Is the problem lack of creditworthy borrowers or are banks unable or unwilling to lend?

And frankly, have changes in supervisory policies exacerbated the recession? Have there been changes that are appropriate precautions that deal with safety and soundness concerns, or have those changes valued loans and real estate on a liquidation basis, which I believe is inappropriate for bank lending?

Will lower interest rates be able to achieve their purpose of stimulating the economy? Or, are other measures needed to prevent the economy from sliding into a recession far more severe than what we're now experiencing?

Mr. Chairman, today's testimony should clarify how much of the current economic downturn is attributable to the behavior of banks, how much to rising oil prices, and how much to the Federal Reserve's own monetary policies.

But most importantly, we need to know if the economy will regain its footing with only the Fed's prodding or whether other actions may be needed, perhaps, here in the Congress?

I thank you, Mr. Chairman, and I'm delighted to see Chairman Greenspan here.

The CHAIRMAN. Thank you, Senator Dixon.

Senator D'Amato?

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. Thank you for convening this hearing today to discuss the Federal Reserve's semiannual Humphrey-Hawkins report.

Chairman Greenspan, the last time you appeared before the full Senate Banking Committee on January 23, 1991, I rather emphatically urged the Federal Reserve to take some affirmative action to stimulate the economy by lowering the discount interest rate.

In fact, the Federal Reserve did lower the interest rate 1 week later on February 1, 1991, to 6 percent.

In the interim, President Bush had also made his position on interest rates clear in his State of the Union address, in which he declared, "Interest rates should be lower."

I'm happy to note that you obviously listened to the President's directive.

The Federal Reserve should stop acting like the cowardly lion, and lower interest rates further to 5.5 percent—the point interest rates were at for an entire year, beginning in mid 1986, before the Fed began its seemingly relentless contradictory monetary policy. It is hard to justify why interest rates are not lower now, given the present state of the economy. And I'll touch on that as we go along.

The Fed is letting long-term concerns about inflation cloud its short-term vision about the state of the economy.

The last time I said I doubted that the Fed was in the real world. I still believe they're having difficulty recognizing the real situation.

The economy is worse now than it was in 1986. After 8 years of unprecedented growth, the U.S. economy is in the midst of a recession. There is a war in the Persian Gulf, uncertainty about the price of oil, the continued cost of the savings and loan clean-up, and increasing insecurity about the banking industry.

The unemployment rate has risen from 5.3 percent last June to 6.2 percent in January. Housing starts are now down 12.8 percent since the beginning of 1990. And auto sales have not looked as bad since the recession in 1982.

Now from August 1986, until August 1987, the discount rate set by the Federal Reserve Bank of New York remained at 5.5 percent. Today, it's at 6 percent.

I find it hard to understand. I find it impossible to understand. I find it illogical.

Now for most of this period, the prime rate charged by banks was 7.5 percent. However, after August 1987, once the economy responded to needed resuscitation, the Federal Reserve abruptly reversed course and has since consistently instituted a monetary policy aimed at slowing down the economy.

Well, it slowed down. It's in a tailspin. It stalled out. You stalled the plane out and it's headed down.

Now most of us have seen this recession coming for months. Apparently, however, the Fed must have been looking in the wrong direction.

Chairman Greenspan, clearly, you have been looking the other way. The Federal Reserve did nothing to head off the effects of a slowdown in the economy. The GNP began to slow noticeably during the second quarter of 1989. Curiously, concerned about overexpansion, the Fed sat by and watched while the GNP continued its descent to an annual rate of 2.1 percent for the fourth quarter of 1990.

The Fed sat on its laurels for months before taking any action to ease the money supply; in effect, letting the recession run its course.

As we all know, problems don't just go away if you pretend not to see them. They just get worse. Now, even if the Fed was concerned about inflation, it took no visible action to accelerate or decelerate the economy. And it's even dubious that the lowering of

the discount rate in December and February was the result of Fed policy or the result of the declining economy.

In December, the Fed announced that it would stop requiring banks to hold reserves against corporate deposits, allegedly to provide more liquidity to banks to stimulate bank lending. The Fed estimated reserves to fall from this change in policy and losses to amounted to $900 million, resulting in rather negligible impact.

The heart of the economy has slowed so much that we can barely find the pulse. The Fed is running around with a full first-aid kit, but is not willing to part with even a tiny band-aid to help the ailing economy.

If the Fed continues to apply contracting monetary policy, there will be no emergency room big enough to save the patient.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator D'Amato.

Senator Heinz?

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you. I join the members of the committee in welcoming Chairman Greenspan back for his first report on monetary policy in 1991.

As several of our colleagues have pointed out, we examine monetary policy at a point in time in which the economic ship of state has run all too hard aground, ending the longest peacetime voyage of economic expansion in our recent economic history.

In short, the negative 2.1 percent fall in GNP in the fourth quarter has taken the wind out of our economic sails.

The Fed has a dual responsibility. One is to fight inflation. The second is to provide adequate credit to permit the economy to grow.

It is no secret that those are sometimes conflicting charges to our central banking agency. Given the fact that the Fed has to navigate these rough economic seas with monetary and credit policy, and in part due to the Fed's action of clearly tightening credit over the last 2 years where M-2 has consistently been below or in the lower half of the Fed's own target ranges, there is evidence that bankers have dropped anchor on extensions of credit, stranding some creditworthy borrowers in unfamiliar waters.

It certainly is a fact that the Resolution Trust Corporation is dumping assets overboard and creating turbulence for already weak real estate markets. There is the very real risk that the tremendous debt build-up over the past decade could create a tidal wave of defaults in a prolonged recession.

It is also all too possible that the American economy may be tossed and turned by events in international waters, as interest rates in Germany and Japan rise.

Mr. Chairman, what's important for the future of course is not necessarily how we got into the predicament we are in, although we may learn from history or our mistakes.

What is most important is what we're going to be doing in the future about reinvigorating our economy.

There is an argument, I think Senator D'Amato also made it in his remarks, that the Fed has basically followed the market down. Probably the most critical writer I have seen of the Fed on this

subject is Dr. Alan Meltzer, a professor of economics who I know Chairman Greenspan knows well. He also hails from my hometown of Pittsburgh and serves at Carnegie-Mellon University.

I ask unanimous consent that the article by Dr. Meltzer appear at this point in the record.

The CHAIRMAN. Without objection, so ordered.

FRIDAY, FEBRUARY 8, 1991
Wall Street Journal

There Is No Credit Crunch

By Allan H. Meltzer

Read any newspaper these days and you are certain to find an article on the "credit crunch." Banks and other financial institutions are reluctant to lend, it is said, because regulators have become so careful about the quality of credit that they force banks to write off good loans as well as bad. Fearing this response, the banks hesitate to make loans. Credit remains tight, almost unavailable.

The alleged result: Worthy borrowers cannot get access to bank loans, making the recession deeper and longer. The problem got the attention of President Bush. In his State of the Union address, he urged sound banks to make more sound loans now.

Specious Arguments

The banking industry would be in even worse trouble than it is if banks had to be coaxed by the president to do what is in their interest. The arguments advanced to explain why banks are refraining from making sound and profitable loans are specious. Japanese banks are supposed to have withdrawn from the U.S. market. Or, as one banker told The Wall Street Journal, "I don't think lower interest rates will induce bankers to lend more." (Of course the banker is right. But, lower rates would induce the customers to borrow more, so some banks would find their loans increasing.) Or, as a governor of the Federal Reserve was quoted as saying in the same issue of the Journal: "Some bankers have lost their nerve and ordered a retreat from their basic business—lending money."

All of this is nonsense—plain old-fashioned nonsense. Repetition has not made the story about a credit crunch true, and it will not. Repetition simply spreads disinformation.

Banks are required to keep cash on hand and deposits at Federal Reserve banks, called "reserves," to limit their ability to issue new loans and deposits. Since reserves do not bear interest, banks try to minimize the amount of reserves they hold, so-called "excess reserves." The only limit on the banks' earning assets is the supply of total reserves. Suppose the Federal Reserve increased the amount of reserves. The banks would not hold the addition to reserves as excess reserves. They would lend, invest and increase deposits to the limit permitted by the larger amount of reserves.

There's the rub. The Federal Reserve increased total reserves by only 0.3% in the four quarters of 1990. The Federal Reserve has been stingy with reserves. Since reserves are the raw material for growth of money and credit, the growth of money and credit has been slow also. The midpoint of the Fed's announced target for M2 (cash and private deposits) growth is 4.5%. M2 grew only 3.7% in all of 1990; in the fourth quarter M2 growth slowed to 2.2%.

I believe the main reason for slow growth of reserves and money is an old one. Interest rates have declined. The financial press, the markets and the Federal Reserve are interpreting the decline in interest rates as evidence of easier money, forgetting that interest rates can decline because spending is falling and the demand to borrow is weak.

The Federal Reserve has been lagging behind the market, as it usually does at the start of a recession. Beguiled by the decline in rates, it believes that it has been easing. But quarter-point cut after quarter-point cut in short-term rates has failed to raise growth of reserves and money, a sure sign that the Fed is following the market down, rather than boldly moving to limit the depth and duration of the recession. True, the Fed reduced reserve requirement ratios, adding more than $11 billion to available reserves. But most of these reserves were withdrawn subsequently.

Banks are not sitting on excess reserves. They are lending, investing and adding to deposits and money as fast as the Federal Reserve permits.

Some might argue that the banks may not be holding excess reserves, but they aren't lending either. They are playing it safe by buying Treasury bills or selling their reserves to other banks. This earns any bank a small, safe return, but doesn't increase lending.

That claim is just as wrong as the other versions of the credit crunch argument. The bank or firm on the other side of the transaction does not hold the reserves idle. No banker deliberately sells an interest yielding asset to acquire a non-earning asset like reserves. Somewhere in the system, someone uses the reserves to make loans and increase deposits. If this were not so, some bank would be holding idle excess reserves. The data tell us that's not so.

The Federal Reserve has been running a disinflationary policy for most of the past three years. I believe that many will be surprised at the lower rates of price increase that will come later this year and in 1992, if the war ends without disruption to oil supplies and the Fed stays the course. The Fed was wise to choose to lower inflation and courageous in announcing that its aim was effective price stability. It would be mistaken if it now abandoned that objective. A highly expansive monetary policy would be unwelcome.

The Fed has announced its targets. Now, let it achieve them. If M2 grows at 4.5% in 1991, credit will grow too. The claim that the credit squeeze has been caused by overzealous regulators and timorous bankers will be shown to be the bunkum that it is.

To the property developer, real estate salesman, builders and others, my denial of the existence of a credit crunch will make no sense. They know that loans that once were willingly offered are no longer available. This is all the evidence they need to conclude that credit is not available.

In a sense, they are right. To be fully correct, borrowers should say credit is not available on the old terms. Lower inflation—or even the anticipation of lower inflation—lowers asset prices, particularly the prices of those assets that are good hedges against inflation, such as gold and land. Land prices are falling, so a 90% loan on a property is a more risky loan than it was before the disinflation started. Adding to the woes of property developers are the special effects of the 1981 and 1986 tax laws that first encouraged and then discouraged commercial building. But, even with these problems, if builders put in more equity to cover the risk of disinflation, they would find lenders willing to lend. Or, if the Fed makes the mistake of inflating again, real estate credit will become available again on close to the old terms.

Shrinking Assets

Yes, some banks are shrinking their assets to meet capital requirements. Yes, the low return on bank capital in recent years is a signal that the banking and financial system does not earn enough to attract new capital. Yes, the Japanese banks have reduced their lending in the U.S. market. Yes, the regulators may want to avoid another taxpayer financed financial bailout.

All true, and all irrelevant to the worries of a credit crunch. If the Fed supplied more reserves, none of the reserves would be held idle. Interest rates would be lower, so borrowing would be higher. The banks would supply more credit, and the empty talk of a credit crunch would disappear.

Mr. Meltzer is professor of economics at Carnegie Mellon University in Pittsburgh.

Senator HEINZ. I hope, Mr. Chairman, in the discussion that follows that Chairman Greenspan will respond to the charge that the Fed has been, in effect, passive, that it has acted too slowly to stem the recession, and that, in fact, all it has done is to react to the fact of market events by adjusting the Fed's policies to reflect what has already happened in the market.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Gramm?

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Greenspan, let me welcome you back before the committee. I'd just like to be brief and reiterate basic concerns that I have.

As I look at the recession, as I look at the economic indicators, I'm encouraged by the fact that I don't see any outward and visible signs that this is a deep and likely to be a protracted recession.

I'm encouraged by the fact that most of the signs are that we're looking at a downturn that the economy should rebound from in the spring and summer.

Much of the discussion along these lines is based on our historic post-war experience where we've had recessions that have lasted about 13 months.

What continues to concern me is that all of that analysis and discussion is based on the inventory cycle that we have had historically in the post-war period where our recessions have been primarily triggered by overexpansion, the building up of inventories, and the economy then going into a retrenchment, adjusting, and then beginning the expansion again.

What continues to worry me about this recession is that it is not an inventory cycle. It is certainly, at least in my mind, a relatively new phenomenon in the post-war period, in that it is a liquidity-induced recession, a credit-induced recession.

Trying to look back at historical examples to try to learn something from the lesson, there are not a lot of good ones and maybe the panic of 1907. Maybe the second phase of the Great Depression certainly had some liquidity and financial elements in it. Not drawing a comparison between this recession in either of those, but simply recognizing that we're dealing with a relatively new kind of phenomenon here in the post-war period. And any time that's going on, it always makes me nervous.

Going back to our dear colleague from Pennsylvania's analogies about waters and anchors, I am happy that we have a good and trusty captain at the helm in monetary policy.

I am a little bit concerned about the constraints that you face, given that you have to deal with two problems—international problems related to America's participation in the world market, the dollar is an international currency, and at the same time trying to provide monetary policy to deal with the domestic recession.

I'd be happy in your testiomony to hear anything about potential conflicts you see there and constraints, quite frankly, that we face today that didn't exist 20 years ago or 40 years ago.

But, in any case, I continue to be encouraged that the recession does not look deep. I continue to be a little nervous about the fact that it is an unusual kind of recession and so, therefore, I don't feel quite as confident as I would given the indicators if this were an inventory cycle.

The CHAIRMAN. Thank you, Senator Gramm.

Senator Mack?

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman. And, again, welcome, Chairman Greenspan.

I want to build on the comments of Senator Gramm. I'm alittle bit concerned as I come back from the State of Florida with the information that I hear, the concerns that I hear both in the banking communities and in the business community about the availability of credit.

I don't see this as the "classical" kind of recession, high inventory levels, pressure because of low numbers of skilled labor. Certainly it's not driven because of excessive inflation.

The sense that this is a recession that's driven by an economy that's overheated just isn't there. At least that's my feeling. And therefore, the question I think is very relevant is how did we get to where we are? Because if we're going to come up with solutions, either driven by the Fed or driven by the legislative or the executive branch, it's important, I think, that we understand what created the environment or where we are today.

So I will be looking forward to hearing your comments with respect to that.

I also will once again bring up the issue of capital gains. I want to pursue why you think it would be better, for example, to eliminate capital gains than, say, to reduce the rate from 28 to 15 percent and pursue the issue of what's happening to the commission.

So, again, I welcome you and look forward to your testimony.

The CHAIRMAN. Mr. Chairman, as you prepare to start your comments, I want to say on behalf of the entire committee that we appreciate the complexity and the difficulty of the job that you and your colleagues have at the Federal Reserve Board.

These are times that try men's souls, and women's souls, in a number of ways.

And so, while you hear from us the feelings that we all have and the things that we're seeing and sensing, we very much value the work that's being done and the relationship that this committee has with you and with the Federal Reserve.

So we'd like to hear from you now.

Before we begin I have statements from Senators Sanford and Roth.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Thank you, Mr. Chairman, and I would like to thank Chairman Alan Greenspan for being with us to discuss the Nation's economic condition and the Federal Reserve's expectations with respect to our monetary policy.

This morning's hearing comes at a very difficult time for our country. As we all know, the economy is currently in a recession. Unemployment has risen significantly from last June; housing starts and auto sales are down dramatically. All economic activity is overshadowed by concerns about developments in the Persian Gulf and uncertainties created by not knowing how long the war will last or what its implications are for our economy.

I share the concerns expressed by my colleagues about the economic condition of our Nation. I am especially aware that some of our economic woes are, in part, a problem of inadequate credit. I believe that we can and should do more to bring an end to the credit crunch we are currently experiencing. This crunch threatens to squeeze not only borrowers of all types, but also the banks themselves and our banking system.

As I have mentioned in previous hearings this committee has held, I believe that we may be headed into a difficult spiral, in which banks and thrifts are reluctant or unable to lend money, due to capital constraints. This inability to lend will lead to further contractions in the economy, which in turn causes business to contract, which then places greater strain on the banking system and the already financially, strapped FDIC. If we do not put a stop to the spiral, it will bottom out in a heap of failed banks, whose deposits were insured by an insurance fund that cannot possibly absorb such significant losses.

I believe we have an opportunity now, before the credit crunch turns troubled banks into failed banks, to stave off the needless collapse of many banking institutions and to provide greater capacity in the banking industry to lend to businesses to get the economy growing again.

We have before us several arrangements to strengthen the capacity of the FDIC to pay off depositors of failed banks. I am not interested in bailing out banks; I am interested in saving those that should be saved.

I will soon be introducing legislation to create an Emergency Bank Investment Corporation. This corporation would be a government-sponsored corporation which could make equity investments in marginally capitalized banks in order to bring greater stability and capital to our financial system.

The corporation would receive a $50 billion line of credit from the Treasury and would, in exchange, issue notes to the Treasury for funds it receives. The corporation would use these funds to invest in preferred or common stock or warrants in banks, and could condition any investment on mergers, consolidations, or changes in management or bank strategy to produce a safer or sounder institution.

This idea has a precedent, the Reconstruction Finance Corporation of the 1930's. Others have suggested different approaches to the same problem—the FDIC has been working on plans to borrow funds through the Federal Financing Board to invest in banks; the Association of Bank Holding Companies has prepared a plan to pool bank capital for such investments; others have suggested using Federal Reserve funds for this purpose; Senator Dixon has suggested that the Federal Reserve require that the banks sterile reserves currently on deposit with the Federal Reserve be held in

the form of bank preferred stock or subordinated debt to create a temporary capital assistance fund.

I hope that in introducing this legislation, we can move this debate along and begin taking action to ensure that our banks have sufficient capital to continue lending. Obviously, and legislation would need to be considered in conjunction with fundamental reforms to our deposit insurance system that permit early intervention into failing institutions and which remove some of the barriers to consolidation and competitiveness.

I look forward to hearing Chairman Greenspan's thoughts on this issue and on how we bring more capital into our financial system.

Thank you.

STATEMENT OF SENATOR ROTH

Senator ROTH. This morning I would like to join in welcoming Federal Reserve Board Chairman Alan Greenspan before the committee.

Given current economic conditions, Dr. Greenspan's testimony today is especially well-timed. The longest peacetime expansion in U.S. history has ended. Real GNP declined in the fourth quarter of 1990 and will probably fall in the first quarter of 1991 as well. Recent reports on industrial production, capacity utilization, and retail sales are all down. The evidence suggests that the recession is continuing.

As policymakers, our first order of business should be to stem the recession and restore the conditions needed for economic growth. Economic growth provides jobs, higher family income, and improved living standards. Given the average length of postwar recession at 11 months, the recession should end fairly soon and economic expansion resume. Lean inventories, and moderate inflation and interest rates, suggest that this recession could be shorter than usual.

However, in the meantime, many of our workers and businesses are under severe pressure. Creditworthy borrowers are having a hard time raising funds because of the credit crunch. I have been hearing from a number of firms in Delaware that the credit crunch is unnecessary curtailing their operations. Whether due to tight monetary policy or regulatory overkill, the credit crunch is a clear and present danger to the health of our economy.

I look forward to hearing Chairman Greenspan's comments on the direction of monetary policy and steps being taken to limit the extent of the credit crunch.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Chairman GREENSPAN. Thank you very much. I very much appreciate those kind remarks, Mr. Chairman. And I, of course, will excerpt from my prepared remarks, with the request that the full text be included in the record.

The CHAIRMAN. OK. I'm going to ask you, if I may, pull that mike just a little closer so that those in the back of the room can hear you as well.

Chairman GREENSPAN. I'm, as always, Mr. Chairman, pleased to appear before you again at these monetary policy oversight hearings.

I should like to start with an overview of the economic outlook. As you know, business activity turned down in the latter months of 1990 and appeared still to be declining through the early part of February. With the unpredictability of events in the Middle East compounding the usual uncertainties attending any economic projection, it would be most unwise to rule out the possibility that the recession may become more serious than already is apparent. Nonetheless, the balance of forces does appear to suggest that this downturn could well prove shorter and shallower than most prior post-war recessions. An important reason for this assessment is that one of the most negative economic impacts of the Gulf War—the run-up in oil prices—has been reversed. Another is that the substantial decline in interest rates over the past year and a half—especially in the past several months—should ameliorate the contractionary effects of the crisis in the Gulf and of tighter credit availability.

The major danger to the near-term recovery is that the erosion in purchasing power and frayed consumer and business confidence stemming from the recession and war could interact with a weakened financial system to produce a further decline in the economy. The recent actions we have taken, along with the ranges for growth of money and credit this year, have been designed to reduce the probability of such an outcome and to support a resumption of sustainable economic growth in the context of progress toward price stability.

When I testified on our monetary policy objectives in July, the economy appeared likely to continue growing, though moderately. The objective of restoring a clear downward tilt to the path of underlying inflation while maintaining the economic expansion, thus seemed attainable. Indeed, data that became available subsequently indicated behavior of economic activity in the third quarter consistent with that appraisal.

That said, evidence in July of weaknesses in certain regions and sectors of the economy signaled caution Notably, deteriorating market conditions for commercial real estate were limiting the ability of some borrowers to service loans, which, along with the restructuring of thrift institutions, induced lenders to pull back from extending credit to this sector. Banks also were becoming less willing to make business loans. In mid-July, to better insure the economy's continued growth, the Federal Reserve adopted a slightly more accommodative stance in reserve markets to counter the potential effect on spending of this tightening of credit terms at depository institutions.

The invasion of Kuwait in early August dramatically altered the economic landscape. Oil prices surged, simultaneously worsening prospects for both real income and inflation. The higher world oil prices transferred domestic purchasing power to foreign oil exporters while uncertainties about how the crisis would be resolved shook household and business confidence. After the invasion, spending held up for a time before starting to soften, while the jump in oil prices fed through quickly to measures of overall infla-

tion. Amid considerable volatility in financial markets and concern about the inflation outlook, bond rates moved back up. When the budget accord was finally reached in late October, its promise of fiscal restraint over the next several years was reflected in somewhat lower bond yields. Against a backdrop of weakening economic activity and in light of the passage of the multiyear deficit reduction package, the Federal Reserve again eased money market conditions.

This policy action proved to be only the first of a series of easing moves extending through early this month. These moves were prompted in part by subsequent information pointing to sizable contractions of consumer outlays and economic activity stemming from the marked weakening of consumer confidence and purchasing power. Following continued moderate expansion in the third quarter, real GNP turned downward, led by the decline in consumer spending, but also reflecting reduced construction activity and business inventory investment. Industrial production began a rapid descent in October. Private employment also started to fall steeply, and the unemployment rate rose further.

The widening economic slack helped prevent the energy price surge from becoming embedded in ongoing wage and price inflation. The success of Coalition military operations after the outbreak of war in mid-January was seen in oil markets as reducing the odds of wide ranging supply disruptions, and oil prices retreated, further improving the near-term outlook for inflation.

This reduction of cost and price pressures has given the Federal Reserve scope to move aggressively to counter contractionary influences on the economy without contributing to market concerns about the inflation outlook. Absent such a lessening of price pressures, monetary policy easing probably would have risked a heightening of inflation expectations, which could have put the foreign exchange value of the dollar under severe downward pressure and fed through to long term interest rates, perhaps even pushing them higher.

The easing of policy also was keyed to the meager expansion since September of the broader monetary aggregates. The slowdown in money growth was worrisome because it seemed to reflect a further tightening of credit availability as well as the weakening in spending. The surfacing of additional asset quality problems has heightened financial strains on many banking institutions, placing pressures on capital positions and boosting funding costs. In turn, banks have progressively tightened their standards for granting loans and have set still more restrictive terms and conditions on the loans they have made. Strains also have been evident at other intermediaries, and many securities have been downgraded by the rating agencies, suggesting that even those borrowers not relying on banks in many cases have faced higher costs and more restrictive terms.

In responding to evidence of economic weakness, to a lessening of inflation pressures, and to slow monetary growth, the Federal Reserve has used all three of its key policy tools. More accommodative reserve provision through open market operations, together with two cuts in the discount rate totaling a full percentage point, have brought the Federal funds rate down to around 6¼ percent.

This important short-term rate has fallen 2 percentage points since mid-1990 and roughly 3½ percentage points over the past 2 years. We also reduced the remaining reserve requirement on nonpersonal time and similar accounts from 3 percent to zero. This action was aimed specifically at relieving the tightening of credit availability at depository institutions.

These economic, financial, and monetary conditions form the starting point for the Federal Reserve's view of economic prospects and plans for monetary policy in 1991. An important aspect of the outlook is the unusually high degree of uncertainty about how these conditions will evolve in the face of the Gulf war and financial strains. Another is the recognition that there may be substantial lags between changes in financial conditions—notably, the decline in interest rates and the depreciation of the dollar in recent months—and the response of spending.

The assessment of the Federal Open Market Committee is that the odds favor a moderate upturn in activity in coming quarters. The lower oil prices, if they persist, will help damp overall inflation, as will slack in labor and capital resources.

The forces currently at work in restraining spending can be readily identified. Consumer and business confidence still looks to be quite depressed, evidently because of the high degree of uncertainty, as well as the weak economy.

The CHAIRMAN. Let me just interrupt for a minute. You've moved ahead to page 11. I know some people are trying to follow your text. I see you're in the first full paragraph on page 11.

Let me let you continue.

Chairman GREENSPAN. Moreover, problems in many parts of the real estate sector are not going to be resolved soon. It also will take a while to correct the associated financial difficulties facing many lenders, who are likely to remain quite conservative in making new loans. Finally, Mr. Chairman, secondary effects on aggregate demand of the recent decline in our economy's output and real income are now in process of running their course.

Fortunately, several stimulative forces are in motion that enhance the chances of economic recovery. Monetary policy easings have brought about a significant drop in short term interest rates. The decline started more than a year before the business cycle peak, a pattern unique in post-war experience and one which should help cushion the current recession. Moreover, short term rates have declined substantially further in recent months. Long term interest rates also have come down appreciably; reduced mortgage rates already have improved the affordability of housing, and thus should help to revive housing sales and starts. The enhanced international competitiveness of our industries augers well for the net export component of GNP. Furthermore, the fall in oil prices, which was especially marked in mid-January, has restored considerable domestic purchasing power. With most businesses having kept their inventories lean, the anticipated pick-up in aggregate demand should show through relatively quickly in rising production.

The 1991 ranges for money and debt growth were selected by the FOMC to promote sustainable economic recovery, consistent with progress over time toward price stability. In keeping with a long

term disinflationary path, the FOMC ratified the provisional ranges set last July, which embody a ½ percentage point reduction in the M-2 range compared with the limits for 1990.

These money and debt ranges are wide enough to afford scope for policy reactions should the economy or its relationship to these financial aggregates diverge from FOMC expectations. Economic forecasters typically have had great difficulty in projecting business-cycle turning points that is, judging when the relative strength of contending economic forces of contraction versus expansion will reverse. Moreover, the current outlook is unusually clouded, in part by uncertainties about the war and its effects. The Federal Reserve will need to remain alert to possible contingencies and will have to continue to respond flexibly to information about evolving trends.

Downside risks in the economic outlook are obviously there and not difficult to identify. For example, an extended war with Iraq clearly could carry some risk of further undercutting public confidence and spending. Additional restraint on credit availability at depositories or increased public concern about the health of the banking system would be negative factors as well, and could show up initially as continued subpar money growth.

The worry has been expressed that, under current conditions of restrained willingness of depository institutions to extend credit, monetary policy easing moves may have only a minimal impact on lending and hence on overall spending. Mr. Chairman, I believe this risk is exaggerated. Our easings and reserve requirement action have lowered bank funding costs appreciably. Some of this decline has been passed through to borrowers in the form of a lower prime rate; even with this reduction, funding costs have fallen relative to loan rates, and with higher profit potential, banks should be more inclined to extend credit. Moreover, monetary policy stimulus works through other channels as well. Some potential borrowers will be encouraged by lower market interest rates to undertake additional expenditures financed, either directly or indirectly, by issuance of securities. Spending effects also can appear through routes involving price responses in equity and foreign exchange markets.

But monetary policy cannot resolve market imperfections in which credit for some financially sound projects is more expensive or less available than might otherwise seem warranted. Structural problems involving imperfections in credit and capital markets require structural solutions. To the extent that current banking regulations are impeding the efficient functioning of these markets, a more promising approach would lie along the path of revising those regulations.

The Federal Reserve is working with other bank supervisory and regulatory agencies to ensure that bank examination standards are prudent and fair and do not artificially encourage or discourage credit extension. The intent of these efforts is to contribute to a climate in which banks make loans to creditworthy borrowers and work constructively with borrowers experiencing financial difficulties consistent with safe and sound banking practices. For example, the agencies are studying steps to clarify that the supervisory evaluation of real estate collateral is to be based not solely upon liqui-

dation prices, but upon the ability of a property to generate cash-flow, given reasonable projections of rents, expenses, and rates of occupancy over time. We need a balanced evaluation process that endeavors to reflect the long-term value of an illiquid asset, rather than the exaggerated appraisals that have been evident in both the upside and downside of the real estate cycle in recent years.

The CHAIRMAN. Let me just stop you there for a moment because you're elaborating on possible adjustments that either are taking place or are proposed to take place.

Are these being reduced to writing? Will there be a uniform code that everybody can see and understand and that will cover all financial institutions? Or is this going to be something that's more amorphous and impressionistic?

How precise is this to be? And where does it stand at the moment?

Can you tell us that?

Chairman GREENSPAN. Yes. Mr. Chairman, in the next several days, under the aegis of the Treasury, the regulatory agencies will be coming forward with written documents relative to these issues which I am raising, and hopefully, they will be at a level of detail which will satisfy your question.

The CHAIRMAN. So the intent, then, is to give us a blueprint that is specific and that will have a uniformity to it, so that it will be one set of rules that applies pretty much across the board.

Is that it?

Chairman GREENSPAN. Well, that's what we're endeavoring to do. Now what will be available in the next few days are the early stages of these particular changes that we are contemplating. Further efforts and more detailed discussion among the agencies to make certain we are essentially bringing our procedures together will go on for a while, perhaps several weeks.

The CHAIRMAN. Well, I think when that is ready, we're probably going to invite in whoever we ought to hear from to discuss that. And we may in turn ask you to come back at that time so that we can be sure that everybody is in sync and that we've got a plan that we all understand here.

Why don't you continue.

Chairman GREENSPAN. Mr. Chairman, the supervisory agencies also are seeking to encourage banking institutions to provide additional public disclosure on their nonperforming assets. Under present circumstances, as best we can judge, the market tends to suspect the worst. Additional disclosure would supplement data on the level of nonperforming loans with information on the amount of such loans that are in fact generating substantial cash income. Other similar steps are under consideration.

In general, we have emphasized our view that prudent lending standards and effective and timely supervision should not inhibit banking organizations from playing an active role in financing the needs of sound, creditworthy borrowers. Such an approach can contribute to the efficient functioning of credit markets and thereby complement monetary policy in promoting the attainment of the Nation's overall economic objectives.

Thank you very much.

[The complete prepared statement of Alan Greenspan follows:]

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Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

of the

United States Senate

February 20, 1991

Mr. Chairman and members of the Committee, I am pleased to appear before you again at these monetary policy oversight hearings. As is the convention on these occasions, I shall focus my remarks this morning on monetary policy and the current situation in the economy. However, the events of the past year have once again underlined the ways in which the state of our nation's banking system can affect the transmission of monetary policy to the economy. Consequently, I think I should comment at least briefly on some of the regulatory issues bearing on the willingness of banks to extend credit.

I should like to start, however, with an overview of the economic outlook. As you know, business activity turned down in the latter months of 1990, and appeared still to be declining through the early part of February. With the unpredictability of events in the Middle East compounding the usual uncertainties attending any economic projection, it would be most unwise to rule out the possibility that the recession may become more serious than already is apparent. Nonetheless, the balance of forces does appear to suggest that this downturn could well prove shorter and shallower than most prior post-war recessions. An important reason for this assessment is that one of the most negative economic impacts of the Gulf war--the run-up in oil prices--has been reversed. Another is that the substantial decline in interest rates over the past year and a half--especially in the past several months--should ameliorate the contractionary effects of the crisis in the Gulf and of tighter credit availability.

The major danger to a near-term recovery is that the erosion in purchasing power and frayed consumer and business confidence stemming from the recession and war could interact with a weakened financial system to produce a further decline in the economy. The recent actions we have taken, along with the ranges for growth of money and credit this year, which I shall be discussing in a moment, were designed to reduce the probability of such an outcome and to support a resumption of sustainable economic growth, in the context of progress toward price stability.

Economic and Monetary Policy Developments in 1990 and Early 1991

When I last testified on our monetary policy objectives in July, the economy appeared likely to continue growing, though moderately. The objective of restoring a clear downward tilt to the path of underlying inflation while maintaining the economic expansion thus seemed attainable. Indeed, data that became available subsequently indicated behavior of economic activity in the third quarter consistent with that appraisal.

That said, evidence in July of weaknesses in certain regions and sectors of the economy signalled caution. Notably, deteriorating market conditions for commercial real estate were limiting the ability of some borrowers to service loans, which, along with the restructuring of thrift institutions, induced lenders to pull back from extending credit to this sector. Banks also were becoming less willing to make business loans--not only for highly leveraged transactions, but more generally where industry or local economic conditions looked at all

unfavorable. Tendencies toward such restraint, which might normally have been expected in a time of uneven and generally less robust business prospects, were exacerbated by pressures on the capital positions of many institutions. In mid-July, to better ensure the economy's continued growth, the Federal Reserve adopted a slightly more accommodative stance in reserve markets to counter the potential effect on spending of this tightening of credit terms at depository institutions.

The invasion of Kuwait in early August dramatically altered the economic landscape. Oil prices surged, simultaneously worsening prospects for both real income and inflation. The higher world oil prices transferred domestic purchasing power to foreign oil exporters, while uncertainties about how the crisis would be resolved shook household and business confidence. After the invasion, spending held up for a time before starting to soften, while the jump in oil prices fed through quickly to energy prices more generally and to measures of overall inflation. Amid considerable volatility in financial markets and concern about the inflation outlook, bond rates moved back up and stock prices moved down, as many investors shifted to more liquid instruments. Treasury bill rates eased, and a surge in purchases of money market mutual fund shares boosted growth of the broader monetary aggregates in August and September.

Oil prices, which peaked at more than $40 per barrel in early October, seemed to be the primary source of financial market uncertainty and volatility; however, the fitful progress toward agreement on measures to reduce the federal deficit also contributed. When the budget

accord was finally reached in late October, its promise of fiscal restraint over the next several years was reflected in somewhat lower bond yields. Against a backdrop of weakening economic activity and in light of the passage of the multi-year deficit-reduction package, the Federal Reserve again eased money market conditions.

This policy action proved to be only the first of a series of easing moves extending through early this month. These moves were prompted in part by subsequent information pointing to sizable contractions of consumer outlays and economic activity stemming from the marked weakening of consumer confidence and purchasing power. They also were taken in response to a lessening of wage and price pressures and decidedly sluggish growth in the monetary aggregates after their surge in August and September. Following continued moderate expansion in the third quarter, real GNP turned downward, led by the decline in consumer spending, but also reflecting reduced construction activity and business inventory investment. Industrial production began a rapid descent in October, with the motor vehicle industry accounting for an especially large share of the drop. Private employment also started to fall steeply, and the unemployment rate rose further. The associated rise in layoffs brought increased uncertainty to the household sector, which in turn has kept consumer spending subdued.

The widening economic slack helped prevent the energy price surge from becoming embedded in ongoing wage and price inflation. The increases in nominal wages and broader compensation measures diminished in the fourth quarter, after exhibiting initial signs of slowing in the

preceding three months. In September, the non-energy component of the Consumer Price Index began to rise at a slower pace. And in the final two months of the year, inflation in the overall CPI fell back, as energy prices topped out in November and declined in December in the wake of lower crude oil prices. The success of Coalition military operations after the outbreak of war in mid-January was seen in oil markets as reducing the odds of wide-ranging supply disruptions, and oil prices retreated still more, further improving the near-term outlook for inflation.

This reduction of cost and price pressures has given the Federal Reserve scope to move aggressively to counter contractionary influences on the economy without contributing to market concerns about the inflation outlook. Absent such a lessening of price pressures, monetary policy easing probably would have risked a heightening of inflation expectations, which could have put the foreign exchange value of the dollar under severe downward pressure and fed through to long-term interest rates, perhaps even pushing them higher.

The easing of policy also was keyed to the meager expansion since September of the broader monetary aggregates. As I shall be discussing more fully, the slowdown in money growth was worrisome because it seemed to reflect a further tightening of credit availability as well as the weakening in spending. The surfacing of additional asset quality problems has heightened financial strains on many banking institutions, placing pressures on capital positions and boosting funding costs. In turn, banks have progressively tightened their standards

for granting loans and have set still more restrictive terms and conditions on the loans they have made. Strains also have been evident at other intermediaries, and many securities have been downgraded by the rating agencies, suggesting that even those borrowers not relying on banks in many cases have faced higher costs and more restrictive terms.

In responding to evidence of economic weakness, to a lessening of inflation pressures, and to slow monetary growth, the Federal Reserve has used all three of its key policy tools. More accommodative reserve provision through open market operations, together with two cuts in the discount rate totaling a full percentage point, have brought the federal funds rate down to around 6-1/4 percent. This important short-term rate has fallen 2 percentage points since mid-1990 and roughly 3-1/2 percentage points over the past two years. We also reduced the remaining reserve requirement on nonpersonal time and similar accounts from 3 percent to zero. The requirement to hold non-earning reserves at the Federal Reserve in effect imposes a tax on credit intermediation at banks and thrifts. This action lowered this tax and was aimed specifically at relieving the tightening of credit availability at depository institutions.

Other short-term market interest rates generally have fallen nearly as much as the federal funds rate since mid-1990. Long-term interest rates also have retreated, and rates on fixed-rate mortgages are now in the vicinity of their lows of the past decade. Lower interest rates and oil prices have helped to lift some major stock price indexes to all-time highs. After firming in December and early January

on safe-haven demands, the exchange value of the dollar has shown unwelcome weakening tendencies at times recently.

The Behavior of Money and Credit in 1990 and Early 1991

As I indicated earlier, sluggish expansion of the monetary aggregates was an important ingredient in the decisions to ease policy during recent months. The broader aggregates ended 1990 well down in the lower halves of their annual growth ranges. The Federal Open Market Committee recognized that the relationship between M2 and spending is uncertain, but the slower growth of M2 in the latter part of 1990 and early 1991 brought the aggregate so far below our expectations that it seemed highly likely to be inconsistent with the Committee's longer-run objectives for the economy.

The weakness in M2 is a complex development and requires careful interpretation. The shortfall from our expectations appeared to be related to the stalling of nominal income in the fourth quarter, and also to the circumstances surrounding the extraordinary decline in assets at depository institutions last year, which in turn had implications for future as well as current spending. As their willingness or capacity to expand their assets diminished, banks and thrifts became less eager to attract deposits of all kinds. Hence, they paid unusually low rates on retail deposits in M2 relative to market interest rates. Moreover, public attitudes toward deposits also seemed to have been adversely affected by developments in the depository sector; publicity about thrift closings, Bank Insurance Fund losses, and credit quality

problems at commercial banks evidently encouraged shifts of funds into Treasury securities or alternative nondeposit instruments.

The shifting of credit intermediation away from depositories appeared likely to be having a damping effect on the spending of those borrowers without ready access to alternative sources of funds at comparable interest rates. Thus, part of the slow growth in retail deposits could be seen as symptomatic of developments in the credit granting process with adverse implications for contemporaneous and future aggregate demand.

However, a portion of the credit flows no longer being intermediated by depositories has been readily replaced by alternative suppliers. In particular, markets for securities backed by mortgages and consumer loans have allowed demands for these types of credit to be met with little or no increase in costs to the ultimate borrowers. And some businesses with relatively high credit ratings have had little difficulty switching from banks to commercial paper markets and other sources of short-term funding. The reduction in funding through retail deposits associated with this type of shift in credit flows would not signal a weakness in current or future spending. Some of the surprising weakness in M2 growth has been reflected simply in a higher velocity than otherwise, rather than having been indicative of restraint on spending. M2 velocity last year did not exhibit the decline that would be expected with the drop in short-term market interest rates in late 1989 and 1990.

But with not all of the weakness in M2 likely to be offset by a lasting shift in velocity, the behavior of this aggregate seemed

increasingly to signal a weaker path for the economy than consistent with the Committee's intentions. Our policy easings over recent months were keyed partly to reinvigorating growth of M2 to a rate more likely to be consistent with satisfactory economic performance. If history is any guide, the policy-induced declines in interest rates on market instruments relative to returns on M2 balances will generate the desired speed-up in M2 growth; indeed, we have begun to see some evidence of that in recent weeks, though it is still too early to be very confident that a new, more robust growth trend has been established.

Restrained growth of M3 last year was expected once the size of the runoff of thrift assets and of RTC activities became clear. But its increase was further depressed by a larger-than-expected decline in bank credit growth. The fall-off in total depository assets had an especially pronounced effect on M3 because this aggregate includes, in addition to retail deposits, certain managed liabilities whose issuance is more sensitive to overall depository funding needs. In fact, currency and money market mutual funds more than accounted for the expansion in this aggregate over 1990. M3 growth has picked up this year, but so far it has reflected the substitution by some depositories of large time deposits for non-M3 funding sources rather than a renewed expansion of their credit.

Although credit outstanding at depositories contracted last year, credit flows at other intermediaries and in the open market were better maintained. Some borrowers undoubtedly felt the effects of

tightening lending terms, but nonetheless the debt of domestic, non-federal sectors rose 5-3/4 percent last year. This growth rate, though considerably lower than in recent years, was well in excess of the percentage increase in nominal income. Growth of federal debt by contrast surged to 11 percent, of which more than 2 percentage points represented federal funding of Resolution Trust Corporation activities. Buoyed by federal government borrowing, the total debt of domestic nonfinancial sectors grew 7 percent, the midpoint of the FOMC's monitoring range for the aggregate.

Economic Prospects in 1991 and Monetary Policy Plans and Objectives

These economic, financial, and monetary conditions form the starting point for the Federal Reserve's view of economic prospects and plans for monetary policy in 1991. An important aspect of the outlook is the unusually high degree of uncertainty about how these conditions will evolve, in the face of the Gulf war and financial strains. Another is the recognition that there may be substantial lags between changes in financial conditions--notably, the decline in interest rates and the depreciation of the dollar in recent months--and the response of spending. The assessment of the FOMC, as captured by the central tendency of the individual projections of Board members and Reserve Bank presidents, is that the odds favor a moderate upturn in activity in coming quarters. Real GNP for the year as a whole is anticipated to grow in the area of 3/4 to 1-1/2 percent. Unemployment is likely to rise further before the recovery takes hold, and consequently the expectation is that the jobless rate will be somewhere between 6-1/2 and 7 percent at year-end.

The lower oil prices, if they persist, will help damp overall inflation, as will slack in labor and capital resources. Most of us believe that consumer prices will rise 3-1/4 to 4 percent this year--the best performance in several years.

The forces currently at work in restraining spending can be readily identified. Consumer and business confidence still looks to be quite depressed, evidently because of the high degree of uncertainty, as well as the weak economy. Moreover, problems in many parts of the real estate sector are not going to be resolved soon. In particular, the large stock of vacant commercial properties is virtually certain to limit activity in that sector for some time. It also will take a while to correct the associated financial difficulties facing many lenders, who are likely to remain quite conservative in making new loans. Finally, secondary effects on aggregate demand of the recent decline in our economy's output and real income are now in process of running their course.

Fortunately, several stimulative forces are in motion that enhance the chances of economic recovery. Monetary policy easings have brought about a significant drop in short-term interest rates. The decline started more than a year before the business cycle peak, a pattern unique in post-war experience and one which should help cushion the current recession. Moreover, short-term rates have declined substantially further in recent months. Long-term interest rates also have come down appreciably; reduced mortgage rates already have improved the affordability of housing, and thus should help to revive housing sales

and starts. The enhanced international competitiveness of our industries augers well for the net export component of GNP. Furthermore, the fall in oil prices, which was especially marked in mid-January, has restored considerable domestic purchasing power. With most businesses having kept their inventories lean, the anticipated pickup in aggregate demand should show through relatively quickly in rising production.

The 1991 ranges for money and debt growth were selected by the Federal Open Market Committee to promote sustainable economic recovery, consistent with progress over time toward price stability. In keeping with a long-term disinflationary path, the FOMC ratified the provisional ranges set last July, which embody a 1/2 percentage point reduction in the M2 range compared with the limits for 1990. The midpoint of the 2-1/2 to 6-1/2 percent range for M2 growth matches the midpoint of the central tendency of the projections by the governors and presidents for nominal GNP growth. The recent sizable declines in short-term market rates normally would be expected to elevate the growth of M2 relative to that of nominal GNP. However, the FOMC anticipates that, as an offset, the ongoing restructuring of the thrift industry, combined with continued hesitancy of many banks to expand their assets, will again create an environment that restrains M2 growth relative to nominal GNP expansion and buoys M2 velocity. An outcome this year involving little change in M2 velocity would be quite similar to last year's experience.

The 1 to 5 percent range for M3 growth this year is the same as the sharply reduced range for last year. It again is lower than the

bounds for M2 growth because M3 is likely to continue to be more depressed than M2 by restructuring of the thrift industry and restrained growth in bank credit. The annual monitoring range for debt, however, has been reduced 1/2 percentage point relative to last year's specification, to 4-1/2 to 8-1/2 percent, in line with the sustained deceleration of this aggregate in recent years.

Risks to the Economic Outlook

These money and debt ranges are wide enough to afford scope for policy reactions should the economy or its relationship to these financial aggregates diverge from FOMC expectations. Indeed, the individual forecasts of Board members and Reserve Bank presidents for the economy cover a relatively wide range. This divergence of opinion has its roots in the major uncertainties facing all forecasters today. Economic forecasters typically have had great difficulty in projecting business-cycle turning points, that is, judging when the relative strength of contending economic forces of contraction versus expansion will reverse. Moreover, the current outlook is unusually clouded, in part by uncertainties about the war and its effects. The Federal Reserve will need to remain alert to possible contingencies and will have to continue to respond flexibly to information about evolving trends.

Monetary policy thus will depend on how trends in economic activity and inflation actually unfold. Downside risks in the economic outlook are obviously there and not difficult to identify. For example, an extended war with Iraq clearly could carry some risk of further

undercutting public confidence and spending. Additional restraint on credit availability at depositories or increased public concern about the health of the banking system would be negative factors as well, and could show up initially as continued subpar money growth.

The worry has been expressed that, under current conditions of restrained willingness of depository institutions to extend credit, monetary policy easing moves may have only a minimal impact on lending and hence on overall spending. I believe this risk is exaggerated. Our easings and reserve requirement action have lowered bank funding costs appreciably. Some of this decline has been passed through to borrowers in the form of a lower prime rate; even with this reduction, funding costs have fallen relative to loan rates, and with higher profit potential banks should be more inclined to extend credit. Moreover, monetary policy stimulus works through other channels as well. Some potential borrowers will be encouraged by lower market interest rates to undertake additional expenditures financed, either directly or indirectly, by issuance of securities. Spending effects also can appear through routes involving price responses in equity and foreign exchange markets. Finally, the anticipated economic recovery itself will help allay problems of credit availability at, and public trust in, depository institutions. Indeed, there is some possibility that once the economy turns around, the expansion could become fairly robust, sparked by a return of consumer and business confidence and fueled by increasing availability of credit.

Regulatory Initiatives

Monetary policy will continue to be conducted to foster attainment of important macroeconomic objectives. In so doing, we will need to remain mindful of any impediments to the process of credit intermediation. But monetary policy cannot resolve market imperfections in which credit for some financially sound projects is more expensive or less available than might otherwise seem warranted. Structural problems involving imperfections in credit and capital markets require structural solutions. To the extent that current banking regulations are impeding the efficient functioning of these markets, a more promising approach would lie along the path of revising those regulations. I would like to offer several thoughts along these lines, some of which are in only the formative stages.

We already have taken the step, as noted, of reducing reserve requirements on nontransaction accounts at banks and thrifts so as to eliminate the reserve tax on lending financed through these sources. This action lowered non-interest bearing required reserve balances at Federal Reserve Banks by some $11-1/2 billion. The Federal Reserve Board also has the authority to reduce the required reserve ratio on transaction deposits from its current 12 percent to as low as 8 percent. However, unusual volatility in the federal funds rate appeared in January and early February, as required reserve balances moved to a seasonal low point. This experience suggests that reserve balances had fallen so far that many depository institutions were encountering difficulties in managing their reserve balances to meet day-to-day clearing

needs. Subsequently, volatility in the federal funds rate has diminished, as required reserve balances have begun to move above their seasonal lows, and as institutions have enlarged their clearing balances. These developments should continue for a time. Even so, the experience early this year suggests caution in considering further reductions in required reserve ratios, at least for a while. We shall, however, continue to assess this situation.

The recent episode of more volatile funds trading also has underscored the increased reluctance depositories have exhibited in recent years in availing themselves of short-term adjustment credit at the discount window. The reluctance has stemmed from fears of being identified as having more fundamental funding problems. Because of depository reluctance, the discount window in recent years has been a less effective safety valve in relieving transitory pressures in the reserves and funds markets. Tapping the window for adjustment credit, when alternative sources of funds temporarily are not available on reasonable terms from usual sources, is not indicative of longer-term stresses at borrowing institutions. Despite bank reluctance, borrowing has been somewhat higher on occasion this year as banks were in the process of adapting to the lower reserve requirements. We would not be surprised to see somewhat higher adjustment borrowing persist. The Federal Reserve has no desire to circumscribe the legitimate use of the discount window, and market participants should not interpret such use as indicating underlying problems for the institutions involved.

Another regulatory area in which possible steps are being considered pertains to the guidelines used in the supervisory process. The Federal Reserve is working with the other bank supervisory and regulatory agencies to ensure that bank examination standards are prudent and fair and do not artificially encourage or discourage credit extension. The intent of these efforts is to contribute to a climate in which banks make loans to creditworthy borrowers and work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices. For example, the agencies are studying steps to clarify that the supervisory evaluation of real estate collateral is to be based, not solely upon liquidation prices, but upon the ability of a property to generate cash flow, given reasonable projections of rents, expenses, and rates of occupancy over time. We need a balanced evaluation process that endeavors to reflect the long-term value of an illiquid asset, rather than the exaggerated appraisals that have been evident in both the upside and the downside of the real estate cycle in recent years.

The supervisory agencies also are seeking to encourage banking institutions to provide additional public disclosure on their nonperforming assets. Under present circumstances, as best we can judge, the market tends to suspect the worst. Additional disclosure would supplement data on the level of nonperforming loans with information on the amount of such loans that are in fact generating substantial cash income. Other similar steps are under consideration.

In general, we have emphasized our view that prudent lending standards and effective and timely supervision should not inhibit banking organizations from playing an active role in financing the needs of sound, creditworthy borrowers. Such an approach can contribute to the efficient functioning of credit markets and thereby complement monetary policy in promoting the attainment of the nation's overall economic objectives.

The CHAIRMAN. Before we begin the questioning period, Senator Graham and Senator Kassebaum have joined us.

Senator Graham, did you have an opening comment to make?

Senator GRAHAM. Thank you, Mr. Chairman. I have an opening statement which I would like to submit for the record.

The CHAIRMAN. We'll make it a part of the record.

Senator GRAHAM. And I would express my appreciation for the Chairman joining us again and, as always, giving us a very valuable insight on complex economic issues.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Mr. Chairman, it is a pleasure to have Chairman Greenspan with us today. The Wall Street Journal on February 15 published a column by Paul A. Gigot entitled, "The Bush Team's One-Man Economic Policy". The article starts with this paragraph:

> The Bush administration issued an economic report this week running to 411 pages. But its essence can be distilled into four words: Let Alan do it.
>
> That's Alan as in Greenspan, Chairman of the Federal Reserve and the Volga boatman of the U.S. economy. He's supposed to steer, row, and plot a course out of recession all by himself. The Bush administration seems to be saying that it'd just as soon sit on the shore with the Democrats, thank you. Best of luck, Alan.

Mr Chairman, I know Chairman Greenspan has a difficult boat to row. Over the last several months, the Fed has been trying to address the credit crunch. Some have said the Fed waited too long to ease interest rates. Others, have said the Fed should just put more money into the banking system and the credit crunch would disappear. But in a New York Times article January 31, Chairman Greenspan is quoted as saying:

> The economic data for last year indicate that the odds are better than even that the country would not have tipped into a recession had it not been for the Iraqi invasion, an event he could not have anticipated.

Also in testimony before the House Budget Committee, Chairman Greenspan said that if the credit situation did not improve, the Fed would take new policy actions to encourage banks to lend more freely. Among these could be reducing interest rates, reducing the portion of deposits banks must hold in reserve, and changing the way real estate loans are reflected in banks' balance sheets.

I look forward to Chairman Greenspan's testimony today and an update on the credit situation and its impact on consumers and businesses.

The CHAIRMAN. Senator Kassebaum?

Senator KASSEBAUM. I have no opening statement.

The CHAIRMAN. Very good. Mr. Chairman, I think you got a little flavor from the opening comments of the fact that we're all getting a lot of input from business people and others, consumers generally, that there's a lot of pressure and stress out in the economic system.

We're clearly in a recession. I'm sure you saw the reported figures for the automotive industry in the last quarter of last year where General Motors, for example, reported a loss of $1.6 billion. That's in a 90-day time period. Ford Motor Co. lost about $550 million over the same 90 days. And now, of course, we're into another quarter where we've got a very slack condition in the market.

That's just one sector, although it's a big one and it has a lot of down-the-line effects.

I would like you to tell us as directly as you can, can you lower interest rates more at this point? Does the Fed really have the latitude? Should it make the judgment to do so?

LOWERING OF INTEREST RATES

Chairman GREENSPAN. Well, Mr. Chairman, remember that what we are endeavoring to do is to stabilize the economy first and set in place a set of monetary conditions which would enable us to come out of this recession on a track which is noninflationary, such that we will not again be confronted immediately with accelerating inflation, a monetary crunch and another recession following quickly thereon. So the proper policy which we are endeavoring to create is to find that path of monetary expansion, which is engendered by a series of actions either in the Federal funds market, through reserve balances or the discount rate, which will give us the highest probability of coming out of this in a manner which will set us on the path of maximum sustainable long-term growth. And as I indicated here on many occasions, the major danger to our capability for doing that is inflationary pressures taking off.

The major mistakes in monetary policy are often made at business cycle turning points. And it is very difficult to avoid them. One has got to be careful to remember that the effects of monetary policy stretch out many quarters into the future, and it is important to try to make the best judgment we can with respect to how the economy is likely to evolve.

Having said that, when and if we think that further adjustments are required, obviously, we will move as expeditiously as we know how to do.

So I would suggest to you that we are following the economy not only on a daily basis, but I would tell you on an hour-by-hour basis, with an extraordinary amount of data and anecdotal input. It is not an easy task. I cannot say to you that this is a science in which all we have to do is put a few variables into a model and it tells us what to do. But I do say to you that we have an extraordinarily broad structure of data input and analysis which I feel very comfortable with in formulating policy.

The CHAIRMAN. Let me follow up here. On the first page of your statement, you carefully hedge the outlook here. And I want to just read it into the record because you led with this. It says:

> With the unpredictability of events in the Middle East compounding the usual uncertainties attending any economic projection, it would be most unwise to rule out the possibility that the recession may become more serious than already is apparent. Nonetheless, the balance of forces does appear to suggest that this downturn could well prove shorter and shallower than most post-war recessions.

Now there are a lot of carefully chosen words in there. But given that picture which you very carefully portray for us, I'd like to know whether you feel you really have the room to take rates lower even if you wanted to now. Or are we too much constrained by a whole host of factors like the Germans raising their interest rate and the question of what happens to the dollar?

FLEXIBILITY TO CHANGE WHEN APPROPRIATE

Chairman GREENSPAN. At the time we make adjustments, we are obviously looking at all the various markets and all types of responses which may occur. In a general way, I would answer your question by saying that we obviously do have flexibility to move if and when it is appropriate to move. Remember that we have taken fairly significant actions as a result of a much too slow growth in the money supply, and we are now beginning to see results coming from those actions. The money supply is beginning to accelerate.

We are concurrently looking at the credit crunch as being the most critical factor that confronts monetary policy at this particular stage. And, as I've stated before this committee previously and in some detail the last time I was here, there are many things we can do to ameliorate the credit crunch, and we're continuing to build them up. We will continue to move against the credit crunch until it gets resolved. Exactly how that will be done and what measures we will do at what time, I don't think is useful to try to project in advance.

The CHAIRMAN. I'm going to yield after just another comment here. There's a concern that the forces that are loose out there may be such that if what we do to help takes a long time to get there, it may not get there in time.

In other words, we may be far enough behind this problem already in terms of its dynamics, that small adjustments on the margin may be coming too late to have a real-time effect.

Chairman GREENSPAN. Mr. Chairman, we are very conscious of that specific issue and are endeavoring to avoid that particular problem.

The CHAIRMAN. Senator Garn?

Senator GARN. Thank you, Mr. Chairman.

Chairman Greenspan, obviously at this hearing I don't want to get into a lot of detail and certainly not the specifics of the administration's recently proposed plan. But I would like you to respond to my opening statement in a general sense about the linkages between the health of the financial services industry and monetary policy and what your feelings are again in a general sense about us moving forward with comprehensive banking legislation this year.

COMPREHENSIVE BANKING LEGISLATION

Chairman GREENSPAN. Senator, I certainly agree with your opening remarks. I have appeared before this committee on numerous occasions in recent years in full support of modernizing the commercial banking industry and financial structure. And I remain of that view, and I trust that that will be coming forth when I hope we are requested to testify before this committee on the President's bill.

Senator GARN. You can't avoid being requested to testify.

Chairman GREENSPAN. I just didn't want to be presumptuous.

Senator GARN. No. I obviously can't speak for the chairman, but I'm certain he would be inviting you to testify for the 10,000th time, or however many times we have discussed these various issues.

Mr. Chairman, in your statement you note that the Federal Reserve recently eliminated required reserves on nonpersonal time deposits and similar accounts. You raised questions about the efficacy of further reductions of reserve requirements on transaction accounts given the need for clearing balances.

So my question would be, in order to strengthen the banking system, is it time for Congress again, rather than talking about lowering reserves, considering the alternative of paying interest on reserves?

Chairman GREENSPAN. The Federal Reserve, as long as I remember, has been supportive of paying interest on those reserve balances, and we continue to hold that position.

Senator GARN. It seems to me that's long overdue. That's another issue we've discussed for many, many years. Especially when you're talking about credit crunches. We can talk all we want about when you should have lowered the discount rate and by how much and all of that. But it seems to me that it's long past due again that we ought to be paying interest on those sterile reserves. That would certainly provide more money out there within the system which we're certainly talking about now.

I appreciate your comments.

Problem loans at commercial banks in the past have been a lagging indicator in that problem loans have continued to rise even after a recession has ended. Do you expect that this historical pattern would continue in the current recession?

Chairman GREENSPAN. It's difficult to say. I see no reason why the pattern would change. But I must say to you, Senator, I haven't given that much thought to that particular event. Clearly, problem loans have been a larger concern now than we've had in any of the recent past. And I fear they will continue to be so even after the recovery gets underway.

Senator GARN. One of the reasons that many cite that we have slipped into this recession was the dramatic increases in the price of oil after the invasion of Kuwait. Hopefully, the decline in oil prices will have the opposite effect.

In your plans for monetary policy over the coming months, are you incorporating an assumption that oil prices will come down and provide a stimulus to the economy?

Chairman GREENSPAN. Well, Senator, as you know, they are down quite significantly from the somewhat more than $40 peak for light Arabian crude oil. We forecast they will stay in this area. Obviously, it's difficult to make a judgment because we don't know yet how the war will eventually end.

Senator GARN. Oh, yes, we know how it will end. The question is when.

Chairman GREENSPAN. Well, I should say when.

Senator GARN. I just wish I was still young enough to go fly an A-10. I'd be doing a hell of a lot more good than I am sitting here in Congress. [Laughter.]

Chairman GREENSPAN. The reason I say how in this context, is that so far there's been an extraordinary lack of evidence of damage to the oil structure in the Middle East. I have every reason to suspect that that will continue through to the end of the war.

Should that be the case, then we have a highly balanced supply of oil output and resources relative to demand, and I see no reason why the oil price should work its way back up. We are forecasting that it will not. And that obviously means that the purchasing power which was extracted from the economy as the prices went up, has been restored.

What hasn't been fully restored is consumer confidence because, concurrent with the sharp rise in oil prices and the uncertainties which attended the invasion of Kuwait by Iraq, consumer confidence plunged at a rate I have never previously observed. While there is some evidence very recently that that is beginning to come back, it's like a frayed nerve which take a very short time to create the problem, but it takes a while to work back. It's that perhaps, just as much as the purchasing power issue, that is relevant to the nature of the recovery that we see most likely in the near term future.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Before we go to Senator Graham, Senator Wirth joined us.

Did you have an opening comment?

Senator WIRTH. [Nods in the negative.]

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman.

There have been a number of explanations given for the restriction on credit that much of the business community has been experiencing. A recent study by the National Federation of Independent Businesses surveying 2,300 small businesses concluded that the reason was because loan demand had slumped substantially. Others have placed the responsibility at the feet of the regulators for setting standards that have either actually or through intimidation caused intermediaries to be reticent to make loans. Others have placed it at more fundamental economic factors, that there weren't quality loans available to be made.

Given the central role that you have given to the re-establishment of a flow of credit to regenerate the economy, what is your analysis of what is the pathology of the current situation?

And based on that analysis, then, what further prescriptions would you have beyond those that you have outlined in your opening statement?

LOAN AVAILABILITY

Chairman GREENSPAN. Well, Senator, it really is caused by all of the elements to which you allude. Obviously, the major contraction in loan availability is coming from the demand side in the sense that there are fewer creditworthy loans. In any period of recession, obviously, there are fewer projects forthcoming which satisfy ordinarily cautious bankers. That's the typical pattern that goes on in a business cycle, and the substantial part of the pattern of loan demand and the balance between bankers and borrowers largely reflects the historic pattern which is being reproduced here.

Superimposed on top of that, however, is a very unusual phenomenon which is restricting credit from the supply side. And that results from, as I've indicated here previously, a response on the

part of bankers to what had been rather lax loan standards in the mid-1980's, a resultant sharp rise in nonperforming loans, a severe threat to the capital position of the individual bank, and a consequent implied rise in funding costs that occurs as a consequence of that in the open market.

Leaving aside the supervisory issue, this clearly has induced a number of bankers to be very chary in lending, for fear that they would further erode their capital position and make it far more difficult for them to obtain low cost funds in the market because, obviously, those who are looking at banks with poor capital positions are increasingly reluctant to put funds in these banks at other than very high rates.

In addition, as you point out, we do suspect that partly as a reflection of the lax lending standards of the mid-1980's, there were also lax supervisory standards during the same period. And having seen the consequence of that, it is human nature to pull back in a way in which a number of supervisors have. What we have perceived is a tightening of standards which goes beyond what we perceive to be required for the long-term safety and soundness of the banking system.

So, in our view, what has to be done here and what we are in fact doing is lowering interest rates, lowering essentially the cost of funds to the banks, to try to open up their profit margins and give them greater incentives to lend to creditworthy borrowers, to lower reserve requirements as we did, and, as I indicated earlier, to take a look at the supervisory process to make certain that we are not involved in overreacting in an irrational manner to the events that started in the middle 1980's.

Senator GRAHAM. In the time remaining, I'd be interested if you could elaborate on what you think were the circumstances that caused that laxity of lending standards that occurred in the mid-1980's to which you ascribe a substantial number of current problems.

Chairman GREENSPAN. It's difficult to be very specific, but there clearly are a number of factors. First of all, in 1981 we changed the tax codes with respect to real estate, which engendered a dramatic rise in real estate investment and market values in real estate, which began to embody themselves directly in the appraisal process of commercial real estate lending.

Those rules were reversed in the Tax Reform Act of 1986, having been recognized that they had been too expansionary. And, having already made substantial loans to projects which had been moving forward in a very dramatic manner, the die, in effect, was cast, and it was very difficult to pull back, although, in many instances, a number of banks were successful in pulling themselves back to the position where the real estate loan hangover was of modest proportions.

The CHAIRMAN. A very interesting subject about which we could speak at much greater length.

Senator Mack?

Senator MACK. Thank you, Mr. Chairman.

CAPITAL GAINS TAX

Chairman Greenspan, the last time we had an opportunity to talk at a Banking Committee meeting, I raised the question about capital gains, and I was obviously pleased at your response that you thought we ought to move forward with a reduction.

You went even further in saying that you believe that we would be better off if we eliminated capital gains.

Chairman GREENSPAN. Capital gains tax.

Senator MACK. Capital gains tax. Excuse me. A very important distinction.

I'd be interested in why you feel that eliminating the capital gains tax would be helpful, why it would be better than, say, 28 percent or 15 percent?

Chairman GREENSPAN. Senator, as I implied the last time I was here, my view on this issue goes back a number of years. It really rests on a notion of the best means or, to put it the other way, the least worst means, of a Government raising revenue.

I've always held the view that taxation of capital gains was the least desirable means of raising revenue if one's purpose is to maintain a maximum of incentive and growth in the economy. And I've seen nothing to alter my view in recent years on that particular subject matter.

Senator MACK. What is it about capital gains tax, then, that destroys the incentive to invest? What is it that the capital gains tax does that slows down the economy?

Chairman GREENSPAN. It's obvious that to the extent that one is taxing gains on property, you will reduce the incentive to invest in property and in assets which improve productivity and expand the economy.

The issue here is not a question of its impact. The issue basically is what are the alternate means of taxation and how they impact on the economy. And it's always been my impression that there are far better ways of raising Federal revenue or, for that matter, State and local revenue, than inhibiting incentives to invest in capital assets.

Senator MACK. There are those who claim that by lowering the capital gains tax, you actually would increase the revenues to the Federal Government. Some people explain it in the sense that it's a voluntary tax, that if you think the tax rate is too high, you're not going to sell an asset. If you don't sell it, there's not a revenue, a revenue to be taxed.

Do you share that idea, that by lowering the capital gains tax and/or eliminating the capital gains tax, that you could actually increase revenues to the Federal Government?

Chairman GREENSPAN. Senator, I am familiar with a good deal of the literature on the subject, but I cannot say to you that I feel confident on either side of that argument because it is a very complex statistical calculation with an extraordinarily large number of assumptions, some of them implicit, some of them explicit. And I have not ventured sufficiently far into the data themselves to be able to give you what I would consider a useful view.

Senator MACK. Given your neutral reaction to that question, it's hard for me to understand why there are so many Democrats, and

I believe that Chairman Rostenkowski had written to you and indicated in essence this idea of putting together a commission. It's going to go nowhere. They don't want to participate in this.

Again, given your kind of neutral reaction to that question, why is there a hesitancy to move forward with an investigation to see whether this would be, reducing this tax would be good for the economy, reduce the cost of the S&L bail-out, increase the value of all assets, determine whether there is any validity to—there would be an increased revenue flow to the Federal Government as a result of a lower capital gains rate.

Chairman GREENSPAN. You're asking me to answer that question?

Senator MACK. Yes. Sure.

Chairman GREENSPAN. Why?

Senator MACK. That's my question—why?

Chairman GREENSPAN. As I recall, the issue has been raised, and I think quite correctly that the major question with respect to the capital gains tax is in fact the same issue that I raised, namely, is it an appropriate tax or not? And it has nothing to do with the technical statistical issues.

There are legitimate differences there. I hold one view and others hold other views. In many respects, a decision on that particular tax should largely rest in the political realm, and there are obviously, significant ongoing discussions of that.

Having said that, what the President obviously is harking back to is the experience that we had with the Social Security Commission, in which we also had very significant philosophical differences about how that program should evolve. And yet, what we did find was that a goodly part of the differences which appeared on the surface to be philosophical was really statistical.

What the President in his State of the Union message was suggesting was to formulate a technical study group which would, with the assistance of the bipartisan leadership of the Congress and the administration, bring together groups of people who might be able to ferret out those issues which are truly value judgments and those which are technical and statistical.

My own view is that the President is probably correct in that respect. There probably are a number of issues which could be clarified and put aside so that they would not be subject to the political value judgment debate, which is obviously the more important aspect of this whole question.

Senator MACK. Do you believe you're going to be able to put that commission together?

Chairman GREENSPAN. I hope so. I think it would be useful to be able to do that but I'm awaiting the views of the President, the administration, and the bipartisan leadership of the Congress with respect to what type of assignment they would like us to pursue.

The CHAIRMAN. Just before yielding, to give a little feedback on that because the topic has been raised.

I support the idea of taking a look at the issue in some sort of an arm's length way. I think that's one way to get it, in a sense, out of the political process somewhat and to examine it because I think it's an important question and it ought to be looked at with as much objectivity as possible.

Having said that, if there's a man in Washington that has his hands full today other than the President, it would be the Chairman of the Federal Reserve. And not just with all of the problems that you've talked about today with the economy in recession, but there's also a major banking reorganization plan that's before us, and we're going to have to deal with that. That has major implications for the Fed, and you've got feelings on that that you've already touched on.

I think capital gains taxation is a highly politicized discussion. And I think this is probably the wrong man to put in the middle of a highly politicized situation, especially when his own term—as Chairman later this year, and on the Fed Board generally early next year—is expiring.

I'm not sure it's fair to the Chairman to ask him to take on that additional duty with all of those additional elements. I'm just expressing a personal view on this. I don't ask him to respond to it.

Senator MACK. But, Mr. Chairman, if I could. Let me just say that I'm encouraged by your comments with respect to wanting to look into the differences and the details and the statistical analysis that needs to be done to make a determination about whether this is the right policy, it's the wrong policy.

I'm encouraged by that because I think the last time we did that was 1977, and the conclusion of the Congress was that we ought to lower the capital gains rate.

So, again, I'm encouraged by your comments.

The CHAIRMAN. I suspect that this is one assignment that the Chairman probably doesn't need.

Senator Dixon?

Senator DIXON. Thank you very much, Mr. Chairman.

Mr. Chairman, others have talked to you about this question of the credit crunch. And I refer to your language on page 17 of your testimony, where you say:

> For example, the agencies are studying steps to clarify that the supervisory evaluation of real estate collateral is to be based not solely upon liquidation prices, but upon the ability of a property to generate cashflow, given reasonable projections of rents, expenses and rates of occupancy over time. We need a balanced evaluation process. and so forth.

Now, very frankly, in simplistic terms—and I think a great many members of this committee are experiencing this with their constituency groups—very reputable people who are obviously very creditworthy, people who I respect—and I suspect that my friend from Florida was referring to the same kind of people in his early remarks and so forth—are coming to me and saying that we can't get sufficient credit now, we can't get sufficient capital to do a lot of things that we'd like to do.

And I think what they're telling us is—well, some are expressing it, but I think inferentially, it's always there—that there's some regulatory impediment here. At least that's the feeling they leave me with.

Now I'm not here to advocate, I hope you know, Mr. Chairman, you and I have spent a lot of private time visiting about our concerns about what can be done about the banking industry, the necessary legislation we need to pass this year. And I know that you

and I share a lot of common views. And we're going to do a lot of things this year.

I'm not here to advocate loose supervisory practices. We saw what happened once before when that occurred.

But have we turned the screw too tight in some places? I think some people are beginning to wonder. Are we examining this carefully in our regulatory agencies to make sure that there's adequate capital and adequate credit available for creditworthy people that are wanting to make sound business investments?

Chairman GREENSPAN. I don't think there's any question that looking at the changes in regulation and supervision as they existed in the middle 1980s and now, we've had a major swing. And my suspicion is that we exaggerated on both sides. There's a technical reason why this probably tends to be the case. While obviously, appraisal values of collateral are not the sole determinant of a commercial loan, they are nonetheless a significant element in the lending process. An appraisal, by its nature, is almost invariably a value that is put on a property for short-term sale. That's what it means, mainly. Yet, a loan on a property is not a short-term loan. It is a loan over the life of the instrument, and the value and the ultimate profit of that loan is determined by the repayments of the borrower over the life of the loan.

If you enter into a process by which real estate values first surge and then decline, and that is reflected in the appraisal process appropriately, invariably, to the extent that supervision locks into that process, you effectively will create an environment in which what you are examining is not the normal, basic, illiquid, long-term loan process which is what commercial banking is all about, but you will endeavor to get to essentially a mark-to-market, short term evaluation, and that will create and, indeed, my own suspicion is it has created, a significant difficulty.

Now, it is that issue which the regulators are now addressing, and as I indicated earlier, within a few days, we, under the auspices of the Treasury, will be discussing this issue in some detail.

Senator DIXON. Well, thank you very much. I had to leave the room briefly, Mr. Chairman, to return a telephone call regarding an important matter, so I missed some of the earlier discussion.

But I appreciate very much your indicating that you are giving this a good deal of attention. I think many of us are quite concerned. And I understand how these extreme swings can cause some disarray from time to time. But I appreciate the fact that you're watching that very closely, because I think many of us are convinced that there is a problem out there that needs our very careful attention.

I respect very much your views and I hope that you are giving this your careful attention.

Chairman GREENSPAN. Thank you.

Senator DIXON. Thank you.

The CHAIRMAN. Senator Dixon, on that point, I think you're exactly right. You've stated it as well as anybody. We've indicated today, and you may have been out of the room, that we're probably going to invite the team back, including Chairman Greenspan, when they have mapped out exactly what these adjustments are that they're going to put forward in a public way.

And I gather that it's going to be within a matter of days that you're going to conclude your work, or is that not the case?

Chairman GREENSPAN. We are fairly close. Secretary Brady has called a series of meetings that we have been at and we're getting close to a conclusion of our deliberations.

Senator DIXON. Excellent.

The CHAIRMAN. So as soon as they're ready to do that, Senator Dixon, we intend to ask them to come in and be available to discuss that in detail.

Senator Kassebaum?

Senator KASSEBAUM. Thank you, Mr. Chairman.

Chairman Greenspan, I'd like to explore with you just for a moment some observations that were in the last issue of Business Week regarding whether the Fed's ability to address the issue perhaps—the tools are just inadequate for the particular time.

You've to a certain extent implied that there is a recognition of this because of the regulatory and structural changes that you're looking to.

But when you say that the money supply is beginning to accelerate, I really wonder if you feel it is going to make a difference at a time when the reserves have been eroded by just the financial system changes that we've seen, the nonbank banks, the securitization of loans, and other innovations that over the past decade have taken place with deregulation. And also, the huge debt overhang.

PUBLIC AND PRIVATE DEBT

I think you spoke in answer to Senator Graham's question very well about the erosion of confidence and all of the factors that have entered into the credit crunch, so to speak, and the public's confidence. But part of that is that there is just such large debt, both public and private. And even with easier money, is that going to really make a difference?

I guess I would just ask you if you feel that with the anticipated changes in both the regulatory process and structural process, that that's going to make a difference? Or have we so dramatically changed to a certain extent, that we really will have to nurture this along in some very different ways?

Chairman GREENSPAN. Well, Senator, as I've testified before this committee in the past, the debt burden has significantly increased. That is, for example, in the corporate area, the ratio of interest payments to corporate gross product, which is the best measure one can use in this context, has clearly gone up quite dramatically. And if one disaggregates the data, there are innumerable clusters of corporations which are borrowing to pay interest. This clearly is a very difficult situation. Nonetheless, in the broadest sense, when you look at the crucial equity—debt ratios in market terms for the corporate sector, there's been very little change in the last 10 or 15 years. So while I think there are strains—and obviously innumerable corporations which are issuers of junk bonds which have had great difficulties, and there are many companies which are on the edge of chapter 11—it would be a mistake to presume that the structure has changed in such a dimension that we at the central bank have our hands tied and can't function in this context.

Obviously, it creates a different type of environment for us to function in. It requires a different calibration, if I may put it that way, in how we do our job. But I have not seen any evidence which suggests to me that the effectiveness of our tools has been so eviscerated that we have ceased to be able to function in a manner that we have in the past.

Senator KASSEBAUM. I thought an interesting figure was, as you well know, between 1978 and 1990, the total nonfinancial domestic credit soared by $7.3 trillion, while M–2 rose by just $1.9 trillion, falling from 44 percent to 32 percent of total credit.

Now, is that an imbalance that concerns you?

Chairman GREENSPAN. No. There has been a very significant decline in the share of depository institutions generally in the credit flows relative to total domestic nonfinancial debt extensions.

That is a process which is reflective of the changing structure of banking and depository institutions. It's the type of issue which we raised in earlier hearings with respect to the so-called Proxmire bill 3 years ago and noted that the nature of banking is changing, that the securitization process has changed, and that the relationship between banking, on the one hand, and finance generally, on the other has been altered so that banking is a more limited source of lending than it previously was.

That does require us to change the way we function, but I don't think it suggests that we are unable to make the adjustments which keep the capability of central bank operations pretty much of the type, so far as policy is concerned, that would have been embarked upon 10, 20, 30 years ago.

Senator KASSEBAUM. Thank you. I've run out of time.

The CHAIRMAN. Thank you very much, Senator Kassebaum.

Senator Wirth?

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Greenspan, thank you very much for being here again. We have put a great deal of faith in the Federal Reserve and a great deal of hope that the ability of the Federal Reserve to impact on the economy is going to be effective. And historically, that's been, I think, the case and the Federal Reserve has operated, I think, very effectively and, as an independent agency, very well for the country.

I become concerned, however, as we look at a number of sort of new elements that are moving into this that might limit the ability of the Federal Reserve to use the tools available to it.

For example, the credit crunch we've been talking about, war uncertainties that are out there, the influence of foreign investors in the United States, the whole internationalization of the economy.

Are those having, in your opinion, Mr. Chairman, are those having an impact on the Federal Reserve's ability to impact on the economy? Are they having an ability of yours to control monetary policy? Are these new pressures from the outside so great and different from something that we've had in the past that that really changes your ability to have the impact that historically the Fed has had?

FED IS CONSTANTLY CONFRONTED WITH NEW ISSUES

Chairman GREENSPAN. I don't think there's any question, Senator, that it requires us to readjust how we focus on problems and how we try to impact upon the economy. But, as I said to Senator Kassebaum, I really can't see any evidence which suggests that the bottom line, so to speak, of the capability of monetary policy to function has been in any major way eroded.

Obviously, we are quite cognizant of all these issues that confront us. Clearly, the internationalization question, the credit crunch question, and in the most recent period, the very dramatic decline in consumer confidence as a consequence of the war, are all new issues. But we're always confronted with new issues. If one looks at the evolution of monetary policy starting with the early years of the Federal Reserve, the System has always been changing. The nature of the economy is changing and the interface of the central bank to the economy is changing.

But underscoring that whole process has been the question of what, in my judgment, has been essentially the effect of monetary policy. The system does work. It does require alteration. It does require revision. It does require a review of how we take specific tools to interface with the economy. But we've been able to do that, and I see nothing from anything that I can observe that's evolving which will prevent us from continuing to do so.

Senator WIRTH. If I might follow on that with a question that in part relates to the bank reform proposal, but I know that that's for another day.

The proposal that commerce and banking would be linked, it seems to me, could also have a significant impact on your ability to conduct monetary policy.

Is that a correct assumption on my part?

Chairman GREENSPAN. Yes, it certainly is, Senator. We hope to put before this Committee our views as to how the various different major proposals—the vast majority of which we support incidentally—will affect monetary policy and the interaction of the central bank with respect to the rest of the financial institutional structure.

Senator WIRTH. Well, we should certainly be prepared to have you testify on what the impact of that would be on monetary policy and then to question you about that. And I know, Mr. Chairman, that's for another day. But it seems to me that there's a broad area in here that's very, very important, more than just moving the walls around and getting rid of other pieces of legislation.

All of this can have a very significant impact on you as well.

Chairman GREENSPAN. I certainly agree with that, Senator.

Senator WIRTH. Let me ask you a third, and also, a related question related to the Bank Insurance Fund.

It is my understanding that the industry has proposed using so-called sterile reserves at the Fed. Does this have an impact on your ability to conduct monetary policy?

Chairman GREENSPAN. It might. It depends what that proposal is. It's unclear to me whether what is being recommended is a moving of, as I recall, $2 billion——

Senator WIRTH. $2 billion.

Chairman GREENSPAN [continuing]. Which is what the recommendation was—from the reserve balances out to BIF, or what was being referred to was payment of interest on reserves and doing the same thing. If it's the latter, as I indicated earlier, irrespective of other aspects of the restructuring, we see no difficulty in that specific sense.

But if it is an issue of moving $2 billion of reserve balances, I think it will cause a problem, mainly because of what we've observed in very recent days; namely, that the so-called clearing balances of commercial banks are not far different at this stage from reserve balances. This means that with the hundreds of billions of dollars of transactions that are going on daily, there's a certain amount of clearing balances required to clear all these funds. And it's turning out that those balances are not terribly far from the actual required reserve numbers are, plus certain specific clearing balances.

If, therefore, those monies were moved from the Federal Reserve Banks to the BIF, I think that the commercial banks themselves might find it necessary to replenish those reserves to keep adequate clearing balances. And it would be quite counterproductive, I think.

Senator WIRTH. You'd be right back where you started.

Chairman GREENSPAN. Exactly.

Senator WIRTH. Chairman Greenspan, we thank you very much for being here. My time is expired, Mr. Chairman. Thank you.

The CHAIRMAN. Thank you, Senator Wirth.

Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

Dr. Greenspan, in my State of Delaware, I've heard many of the same complaints that the other senators have been raising about the credit crunch and the state of the real estate market. And I know that you have taken certain initiatives in respect to the former.

One of the questions I would like to ask you is what, if anything, Congress should be doing to try to help restore the real estate market. Its depressed nature is obviously a problem with, not only the savings and loans, but banks and insurance companies as well.

Now we have a lot of complaints at home that some of the tax changes, for example, that were made in 1986 have caused the depressed state of the real estate market. These individuals point out to such things, not only the changes in capital gains, but the change in passive losses, the change in depreciation, the change in investment tax credits.

Now many of those changes were, of course, made in the belief that the real estate market had overbuilt for tax reasons rather than for market reasons. But I know that there is a very strong feeling, not only in my State, but abroad generally, that these tax changes have seriously hurt the real estate market.

Are there any changes either with respect to taxes or otherwise that Congress should be dealing with in an effort to help out this unfortunate business?

POSSIBLE CHANGES TO RESTORE DEPRESSED REAL ESTATE MARKET

Chairman GREENSPAN. Senator, you express it exceptionally well. It's a dilemma. The only change that I would be inclined to make with respect to your remarks is to reiterate what I said here earlier before you came in, namely, that one of the problems that we had was that in the 1981 Tax Act we created, as you put it, what in retrospect was very clearly excessive incentives to produce commercial real estate. And this, I think, was appropriately adjusted by the Congress in the 1986 Act. In the interim, unfortunately, we built up a huge amount of real estate construction to a substantial extent, tax-based or tax-induced so that we ended up with very large vacancy ratios which are the concern that we have at this point.

It's been a major problem in the credit crunch. In fact, if I were to point to a specific thing, and one shouldn't point to one specific thing, but if I were to say what bothers me most about the credit crunch or where did it come from, so to speak, this is where the major part originated, although, clearly, there were other elements in the commercial banking system such as the loss of certain competitive capabilities of commercial banks. That is, for example, the moving of commercial paper lending to a substantial part out of the commercial banking system, and that led the banks to reach for loans, which probably was, in retrospect, not the appropriate thing to be doing.

But having said that, real estate, in that context, is the major issue.

Our choice, basically, as you imply, is that we change the laws back to try to regalvanize this sector. And that's probably not appropriate. It just makes things worse rather than better. It is better to try to absorb as quickly as we can, through a growing economy, the excess overhang of commercial real estate vacancies. And I'm not certain that, with the exception of the discussion that Senator Mack and I had here at an earlier Committee hearing with respect to the effect of the capital gains tax on real estate evaluations, there is anything to be focused on with respect to actions by the Congress.

I'm not saying there is not, but I can't, off the top of my head, address your question in a productive manner.

Senator ROTH. If I could change to a slightly different area.

GATT NEGOTIATIONS

As you well know, we're faced with the possibility of the GATT negotiations failing. If the President doesn't get extended authority or request extended authority by March 1, that the "fast track" be permitted to continue, it looks like the Uruguay Round may go down in failure.

How important do you think that factor is to the state of both our economy and the world economy? Is this something that we should be seriously concerned about?

Chairman GREENSPAN. Senator, it is a major problem and a major issue because all of the evidence I've been able to accumulate suggests that the extraordinary rise in trade over the post-

World War II period was a major contributor to growth and living standards not only in the United States, but throughout the world.

The Uruguay Round is merely an extension of the process of opening up trade, and in this particular instance, for service as well, in a manner which is so clearly desirable that it is very difficult to conceive of our turning our backs on this whole process.

If the fast track fails and the Uruguay Round comes to a halt, essentially moribund, I think we in the United States and our trading partners throughout the world will pay a significant price.

Senator ROTH. Could I ask just one final question, Mr.Chairman?

The CHAIRMAN. Yes.

Senator Roth. And that's in connection with savings. As you know, I have been a very strong proponent for many years with some kind of an IRA, whether front-ended or back-ended.

It appears that there's a good chance that there will be bipartisan support for such an approach. And of course, the administration itself, the President, in his State of the Union address, talked about a back-ended family savings program.

Would you care to comment on the importance of this kind of an initiative to future savings?

Chairman GREENSPAN. Senator, as you know, I am fully supportive of any actions which will increase the saving rate in this country because if I were to try to stipulate what is the most important long-term problem that confronts this country, it's clearly lack of saving. So anything which will move us appropriately in that direction should be examined.

Without looking at the detail of the specific proposal, I don't consider myself adequately prepared to address the specific nature of your proposal. But if you would like me to do so in a follow-up letter, I'll be most pleased to do that.

Senator ROTH. I would be most happy to have those comments. I always appreciate hearing from you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Roth.

Senator Kerry?

Senator KERRY. Thank you, Mr. Chairman.

IMPACT OF WAR ON THE ECONOMY

Mr. Chairman Greenspan, when you I think were here last time, or either before the House or here, you made some comments regarding the impact of the war on the economy.

I wonder if at this point you might just give us your assessment, whether there are any surprises that you perceive, whether your pronouncements at that time still hold, or whether there is an unforseen impact of the war.

Chairman GREENSPAN. Well, Senator, I don't fully recall exactly what I said the previous time.

Senator KERRY. You talked about a long versus short war and the impact it might have on the recession. I wonder if at this time, given the course of the war and the oil price situation, which I know you mentioned earlier, whether you feel the economy is essentially unaffected by it, or whether there is any long-term consideration that we should be giving.

Chairman GREENSPAN. Senator, there's very little doubt in my mind that the onset of the invasion by Iraq of Kuwait created a set of forces which undercut this economy in an extraordinary way, more so than I would have anticipated. It wasn't so much the rise in the price of oil, but the remarkable decline in consumer confidence and fears. That seems to be abating since the war actually began with the Coalition partners on January 6. I recall vividly sitting by my computer screen on the night of the invasion with the air attacks on Iraq, and it became fairly clear at that point that the war would not evolve into a pattern which would create a major destruction of oil resources in the Middle East.

And when that became apparent as the night evolved, youcould basically see not only the price of oil coming down very sharply across the world, but you could see the effects minute by minute in the exchange markets, in the interest rate markets, in the gold markets, all arbitraged around the world in a manner which was suggestive of the type of basic change which I think is beginning to emerge in a positive direction at this point.

As I indicated earlier in this hearing, even though the improvement in consumer confidence has been very modest since January 6, it is definitely there, and we're beginning to see a gradual emergence of positive consumer attitudes. That clearly suggests that if the war were to end shortly, that it would be a positive effect.

But so long as it is clearly apparent that the oil reserves of the Middle East are not threatened by war, I think confidence will continue to improve in this country.

Senator KERRY. Is there any reason that the economy or the circumstances that you've cited that might affect it, would be differently impacted by an engaged, prolonged land war or by the continuation of air war?

Is there any distinction in what the impact of the economy would be?

Chairman GREENSPAN. It's very difficult to make that judgment.

Senator KERRY. All right. I just was curious. With respect to the last few months and your efforts in monetary policy, you've cut the discount rate, reduced the reserve requirements and lowered the targets for federal funds.

But there's some indication in a lot of parts of the country, and I sense it now from more colleagues than have been articulating it, that they're still feeling this credit issue.

And I gather the Fed's latest survey of bank lending taken last month finds an overall tightening that has gone on. Does this suggest in any way that banks may not lend, notwithstanding the reduction in the interest rates, that the interest rates won't move them, that it's going to be significantly more than that needed?

Chairman GREENSPAN. Well, we are engaged in two fronts in this respect. One, we're looking at the supervisory process which, as I indicated earlier, is something which we'll be coming forward with recommendations in some detail within a very few days. We believe it is important to remove some of what is clearly an unnecessary concern on the part of bankers with respect to their capital positions, which is the source of this problem.

And second, we are endeavoring to keep pressing on commercial bank profit margins in a manner which will also remove their con-

cerns about the profitability of the types of lending which we think they should be moving forward on to creditworthy borrowers.

My impression basically is that as the economy turns, and we do think the likelihood is that it will be turning and starting to move higher in conjunction with these two forces, provided we get the money supply moving in an appropriately balanced direction, we'll begin to see the easing of the credit crunch.

But I agree with the implications of your remarks at the moment, even though earlier on, there were sporadic signs that some of the forces which could bring this credit crunch ultimately to a halt were beginning to emerge.

The fact of the matter is that it is still there and it's still tight and still requires, in our judgment, continuing and unrelenting effort until we get it resolved.

Senator KERRY. Well, I certainly want to concur with that judgment. I suspect we're going to hit the double digits in unemployment in New England very quickly, and it continues to be disturbing.

Mr. Chairman, the time is up, but I have just one follow-up. Could I ask it?

The CHAIRMAN. Please.

Senator KERRY. You're busy right now, as I think we ought to be, expanding the money supply. The Bundesbank is contracting it.

We are now near 1.44 Deutschmarks, which is the lowest that we've ever been since WW II. I gather before I came in here, and I've read your testimony, you suggested that you still have room to lower interest rates. I think the chairman asked the question and you said, yes, you could go lower.

Can you go lower without creating further problems for the dollar that you mentioned on page 2 of your testimony, which then have very serious implications, I assume, with respect to the debt issue, as well as export trade?

Chairman GREENSPAN. The way I answered the chairman's question is: Technically, could we go lower? Well, obviously, technically, we can. The question really is a policy issue as to whether in fact the implications of moving lower have more plus or negative effects.

Senator KERRY. This is really what I'm getting at.

Chairman GREENSPAN. Obviously, these issues emerge every time we move either up or down. We try to draw a balance of what the impacts are. And clearly, if we perceive that the weight of potential effects is negative, we would hold back.

But in the specific case which you raised, the reason for the difference in the policy between, say, the Bundesbank, on the one hand, and the Federal Reserve on the other, is that money supply was growing at an inordinately strong rate for the Germans and their perception was that they had to restrain an expansionary economy which was being galvanized in part by an extraordinary increase in their central government deficit, resulting from the financing of what had been previously East Germany.

We, on the other hand, were confronted with precisely the opposite phenomenon; our money supply growth was deemed most inadequate and we were confronting not inflationary pressures, but what we considered to be clearly contractionary forces.

There's been a lot of discussion that somehow we're going in different directions. But I can assure you that the president of the Bundesbank and myself have had innumerable conversations in recent months over this issue and have kept each other very well informed as to what our policies were and have been coordinating to try to mesh this issue in a manner in which we would not be creating galvanic disruptions in the exchange market, which would have very negative effects back in the United States largely through rises in long-term interest rates here, which would probably have a very negative effect on American economic activity. So the problem is always to endeavor to find a balance, and sometimes it is not all that easy to find.

Senator KERRY. I understand that. Thank you, Mr. Chairman.

The CHAIRMAN. I'm going to continue right along that very same line.

I must say I'm a little concerned if after these coordinating discussions they are still going one way and we're going the opposite way. I'm wondering if we're really able to reconcile our differences in circumstance.

But I want to aplproach this concern a little differently. I want to make two references.

In your report today, the official report that you're conveying to us, on page 4, at the end of a paragraph, a long paragraph that starts on the bottom of page 3, you end up with this statement, which I find one of the most important statements in the report today.

You say, "Because of these problems, the board members and the bank presidents perceive that in the near-term, the risks to the economy may be skewed to the downside."

Now I assume great care went into the construction of that sentence. I take that to be a very important summary judgment coming from the board members and the bank presidents—and I don't mean to leave you out of that consensus view—that the net of opinion is that the risks to the economy may be skewed to the down-side. And I take it that that, together with everything else you've said, is one of the important summaries in this document.

BOTTOMING OUT OF THE ECONOMY

Chairman GREENSPAN. I think that's right, Mr. Chairman. So long as the economy continues to ease lower, we are concerned about the risks that open up on the downside.

As I also indicated in my opening remarks this morning, nonetheless, looking at the objective balance of forces, if one had to make a single forecast, and only one, without looking at risks on either side, it would be one in which the economy bottoms out and starts up reasonably soon.

But that has not happened yet, and until it does and until the process of bottoming out is clearly identified and the movement is in the other direction, I would say that that has to be the view of the balance of where the risks are.

The CHAIRMAN. So is that another way of saying that we do not have yet a composite of meaningful data in hand that would tell us that the economy has in fact bottomed?

Chairman GREENSPAN. What we do have are indications that the decline has not accelerated, but it continues to move lower, and there are additional signs which seem to be very gradually emerging which are consistent with a bottom not terribly far in the future. But we have not arrived there as yet.

The CHAIRMAN. All right. But what I hear you saying, then, is the economy is still headed in a downward direction, and it may be beginning to move into a bottoming position, but you're not sure of that.

Chairman GREENSPAN. That is correct. And I think that it behooves us to be very cautious, especially in a policy mode, and to be very closely aligned to what the day-by-day facts are. We must make certain that we are looking not to theoretical notions of the way the economy should evolve, which we have to, obviously, but we must be very careful about making certain that our reporting is not in any way diluted by our views with respect to the way we think the economy ought to behave.

The CHAIRMAN. Well, let me say to you in slightly different words, there's an awful lot of evidence that I'm getting and my colleagues here on the committee are getting and have made some reference to today that there is a credit strangulation going on out there—not just in commercial real estate, but much more broadly than that—that is hurting a substantial part of the economy.

Now, we're always pushed back on the question of how much of it's anecdotal, how much can be added up and shown in short of real time numbers.

We had a hearing in here 8 months ago on the credit crunch because we were concerned about it at that time and we asked you and others to testify. Based on the picture at that time you said, "Nevertheless, with the exception perhaps of the troublesome situation in the New England region, credit availability more broadly appears not to be significantly impaired."

We were getting more and more signs and signals from people that there was a problem out there stemming from a mixture of this banking problem, revised credit standards, maybe some change in consumer spending, maybe some cyclical recession pressures building up, what have you.

Well, here we are 8 months later and we're getting a lot of information from people who are very concerned about the fact that the economy is still headed down and that there is no certainty that it in fact is bottoming. It may be, but it's not anything that we can be sure of or hang our hat on.

So, with that as background, I want to come back to the question I was raising before, and it keys off what Senator Kerry was just raising, too, with respect to international interest rates and the Germans having just jacked up their interest rates.

Suppose you were to lower the Federal funds rate, say a ½ percent today. I'm not saying do it. I want to discuss with you the constraints that we're trying to operate within here.

I think it's an important enough question that the country has a major stake in understanding what our policy latitude really is.

If the Fed were to decide to lower the Federal funds rate, or the discount rate, say a ½ percent now, are there some negative consequences that we would need to worry about? Because there are an

awful lot of people that feel that that might help get the economy moving at a faster rate, and bring about the bottoming out of the recession. I'm wondering what's holding us back?

What are the dangers that are prompting that step not to be taken?

Chairman GREENSPAN. First of all, Mr. Chairman, the effects of monetary policy are not immediate. In other words, whatever actions we would take today would not have any measurable effects for months.

The CHAIRMAN. If I may just say, I think psychology is a factor and lower rates do affect psychology.

Chairman GREENSPAN. In fact, I was about to make that point. I'm saying that. As I mentioned earlier, we have to evaluate what the effects of previous actions on our part will do as they work their way through the financial system and the economy. And then, superimposed on that, are two other elements. One is the issue that you raise, which really is quite important, which is what is the psychology of the market because, as I've indicated here on numerous occasions, more than at any other time that I recall, this economy is driven by confidence rather than physical forces.

Finally, there is the issue of actions which could appear to be of an easing nature, but turn out to be counterproductive in the context in which I was discussing the issue with Senator Kerry.

One thing we have to be concerned about is to make certain that in endeavoring as we do to lower overnight money rates, short-term interest rates, over which we have a large impact, we do not inadvertently create an inflationary environment or a concern about the value of the dollar which would induce a significant increase in long-term rates, which would be counterproductive over the longer run.

I won't say to you that it is a simplistic activity which we can very readily make easy judgments on, but what we try to do is to focus on all of these elements and come up, as best we can, with policies which have the highest probability of being positive and trying to fend off those types of actions which tend to be potentially counterproductive.

The CHAIRMAN. Well, I must say, I have to conclude from what you're saying, and I realize that it's very difficult to talk about this because everybody hangs on every word you say, especially on this subject.

But it sounds to me as if the Fed has decided that it's gone about as far as it can in lowering interest rates, that if it were to go further, it would create these other negative effects that you're concerned about. And I think those are real concerns, inflation and such as that.

Chairman GREENSPAN. Well, Mr. Chairman, I have very purposefully been slightly evasive so as not to be able to leave such conclusions one way or the other because I do think it is important that we not be in a position where we cannot be responding to continuous data as they emerge over time.

And I don't want to give you an impression of how we will or will not behave because new data are coming in all the time, and our positions are continuously under evaluation. I honestly cannot

tell you whether or not the conclusion that you just reached is really a valid one.

The CHAIRMAN. I'm going to say one more thing and then yield to Senator Heinz. He may or may not want to follow on this. I don't want to interrupt this discussion without one more point.

As you know from the hearings that we've convened on this subject at which you've testified and to which I've referred here, this has been a concern for this committee now over several months.

I think the concern is as great or greater now than it was 8 months ago. I think there has to be a very compelling case on the side of adverse reactions and implications from a lowering of interest rates to prevent policy from moving that way, because we are getting a strangulation of credit in certain areas. I think we have a problem out there. Perhaps you've struck the balance that is the one that has to be struck given the trade-off of these factors. No one knows for sure and even after the fact, one can't go back and measure it with precision.

When you look at your own M–2 rate, you state that M–2 expansion noticeably above the lower end of the range would be needed to foster a satisfactory performance of the economy in 1991. That's a quote. But right now, it's below the lower end of the range. I'm not saying that interest rates alone solve that, but some way has to be found, I think, to get more credit and money, energy, into the system. I'm not sure what other tools are available to you, but I think that question is one that there's a great concern about here.

Chairman GREENSPAN. We are definitely committed to getting the money supply growth in the target ranges in a manner which fosters economic growth.

We're not in a position to sit back and say, we don't care where credit is going or where the money supply is going. Obviously, it's crucial to what this economy does and it's crucial insofar as policy is concerned at the central bank.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. Thank you, Mr. Chairman.

I want to apologize to Chairman Greenspan and to you, Mr. Chairman, that I had to be absent for the last hour or so. If I ask questions, Alan, that you've responded to, forgive me. But I think I know what the discussion has been about.

First question, as we all know, particularly you, the downturn in the real estate markets has been obviously increasing the taxpayer cost of the S&L bail-out. It's severely damaged the condition of the banking industry, not just the thrift industry.

My question to you is to what extent has this downturn in the real estate market contributed to the current recession? And what effect will it have on preventing economic recovery if it continues?

IMPACT OF REAL ESTATE DOWNTURN AND THE RECESSION

Chairman GREENSPAN. You can look at the real estate issue in two ways. First, since commercial real estate construction is a relatively small part of the GNP, it's hard to argue that the decline in activity, which has been fairly pronounced, is a major factor in economic activity directly.

Senator HEINZ. What about home-building?

Chairman GREENSPAN. Well, home-building very clearly is a factor. But the home-building issue is not related to the credit crunch in the sense that what we find is that one-to-four family mortgages are readily available in the market and the major problem with respect to restrictions of credit is very highly concentrated in commmercial real estate.

Senator HEINZ. What about the case of the builders of housing who need credit in order to build?

Chairman GREENSPAN. I was actually, Senator, going to go further and say that, having said that, the effect on the economy is really quite significant basically because commercial real estate is a very long-lived asset. And even though it is only, say, 1 percent of the GNP, it is a significant multiple of that in the total stock of assets in the economy and the collateral which is involved with our depository institutions. And in fact, it's more than depository institutions. Obviously, it involves insurance companies and other financial intermediaries as well.

The decline in real estate values has had a very important impact on commercial banking. It's, as I indicated earlier, a major element involved in the credit crunch, and the credit crunch, in turn, is clearly a significant factor in the repression of economic activity.

So that when one looks at the real estate issue, its major impact seems to be indirect, but——

Senator HEINZ. But real.

Chairman GREENSPAN. But real.

Senator HEINZ. Now I understand that you testified earlier that the Treasury was going to be coming back with proposals to deal with these kinds of issues, credit crunch kinds of issues.

Is that right?

Chairman GREENSPAN. Well, actually, within the next several days, Secretary Brady and the Treasury Department will be sponsoring a meeting in which we, the regulators, will be putting forth our views of how supervision is in the process of being altered. We will be following on from that in more specific details and numbers of written documents.

Senator HEINZ. And I understand the chairman has threatened to invite you back.

Chairman GREENSPAN. He has indeed.

Senator HEINZ. Until you get it right, as we say.

Chairman GREENSPAN. Correct.

FED SLOW TO RESPOND TO POTENTIAL RECESSION

Senator HEINZ. Let me go on to the subject I raised in my opening remarks, where I indicated that what I interpreted as criticism by Dr. Meltzer suggested that the Fed had been too slow in coming to grips with the potential of a recession.

And let me quote very briefly from some of the things that he said. He said:

> The Federal Reserve increased total reserves by only 0.3 percent in the four quarters of 1990. The Federal Reserve has been stingy with reserves. Since reserves are the raw material for growth of money and credit, the growth of money and credit has been slow also. The midpoint for the Fed's announced target for M-2, cash and

private deposits, growth is 4.5 percent. M-2 grew at only 3.7 percent in all of 1990. In the fourth quarter, M-2 growth slowed to 2.2 percent.

He went on as a second point to say that he believed the main reason for the slow growth of reserves and money is an old one. Interest rates have declined. The financial press, the markets and the Fed are interpreting the decline in interest rates as evidence of easier money, forgetting that interest rates can decline because spending is falling and the demand to borrow is weak.

The Federal Reserve, he continues, has been lagging behind the market, as it usually does at the start of a recession, beguiled by the decline in interest rates it believes it has been easing. But quarter-point cut after quarter-point cut in short-term rates has failed to raise growth of reserves and money, a sure sign that the Fed is following the market down rather than boldly moving to limit the depth and duration of the recession.

I read that as severe criticism of the Fed. Where is Mr. Meltzer right and where is he wrong?

Chairman GREENSPAN. Well, let me say that Alan Meltzer and I are old friends and it is very rare——

The CHAIRMAN. Did you say were old friends or are old friends? [Laughter.]

Chairman GREENSPAN. I said are old friends. We are still. In fact, in my recollection is that he also said some very nice things about the Federal Reserve in that article as well.

Senator HEINZ. I'll put the entire article in the record. [Laughter.]

We can get out our magnifying glasses and look for them.

Chairman GREENSPAN. My recollection is he was quite complimentary in certain respects, is of that.

Senator HEINZ. There were no ad hominem attacks in the article, which in this day and age is probably a compliment.

Chairman GREENSPAN. No. Let me tell you, I have the highest respect for Professor Meltzer. I just happen to disagree with him on this issue, and I'll tell you why.

First, as I've indicated earlier, we do share his concerns with respect to M-2 growth, as indeed I've argued here quite extensively over the last several months.

But on the reserve issue, most of our required reserves and, therefore, our total reserves, are on transaction balances. We, in fact, have very little of M-2, other than the transaction balances which are reserved against. And indeed, we just eliminated part of that.

For whatever reasons, transaction balances, very specifically, demand deposits, have become an increasingly less relevant element within the banking system. In fact, some of our surveys suggest that a lot of compensating balances, which historically have been held for purposes of services that commercial banks give customers, are now being substituted by fees.

In the extreme case, if demand deposits and transaction balances were coming down, total reserves would be coming down because the vast majority of reserves are required reserves.

That says nothing about M-2. In a sense, the crucial question is: Is M-2 going up adequately? Our view is that it is not. Alan Meltzer's view is it is not, and we agree with him on that.

On the question of reserves, we disagree.

Senator HEINZ. There really were two questions. One was the growth of M-2 and the Fed's policies that affect the growth of M-2, and the other was on the reserves.

You've answered the question about the reserves. But how do you account for the fact that you have been unable to stay in the middle of the range with respect to M-2?

Chairman GREENSPAN. That is a quite legitimate question. Let me say first that we are not lagging the market. My recollection is that the federal funds rate has come down far more than the Treasury bill rate since the spring of 1989 when we started to ease. That's especially been true of late, which means that we cannot have been lagging the market. At worst, we're consistent with it.

Senator HEINZ. Just to be devil's advocate, somebody might say, well, the reason the funds rate came down faster than the bill rate was that the funds rate already had been jacked up so high, that it was artificially high. And certainly, something had to give.

Chairman GREENSPAN. But that's not what the argument is. The argument in the article is, in fact, that we have been lagging the market. That's a factual issue. And as far as I understand the facts, it's very difficult to defend.

On the question of why the M-2 has lagged behind where we would have wanted it to be, it's essentially because of the fact that all historical analysis would have suggested that the funds rate that was emerging early last year, for example, would have put the M-2 growth rate into a much higher orbit than it eventually did.

Senator HEINZ. That's Meltzer's point.

Chairman GREENSPAN. No, no.

Senator HEINZ. Let me see if I understand his and your point up to this point, which is that, what he's saying is that the Fed assumed because interest rates were going down, that there was a high demand for credit and the Fed interpreted that as something to be not accommodated, but restrained, as opposed to the fact that there was not much demand for credit. Interest rates were falling in response to the lack of demand.

Chairman GREENSPAN. No. What I'm saying basically is that on the basis of historical experience, if you go back to the context of the early months of 1990, and you in fact simulated on the basis of all the relationships that we have—and they're pretty sophisticated—the trend of the Federal funds rate that occurred over the subsequent year, would have put us well within the center range of the targets.

What has happened is that the credit crunch and other elements—I think it's mainly the credit crunch—have bought on a progressive basis the actual levels of M-2 below where we thought policy would lead it.

What that did is induce us to accelerate policy which we wouldn't otherwise have done in many instances. The actions that we took were to adjust for the changes that were in the process of occurring.

We still find that, as I've said before, we have got a rate of growth in money supply, or at least have had, which we consider to be subnormal and have taken actions in recent weeks which seem at this stage to have moved the trend up significantly. And while

it's a little early to make a judgment that the trend is back on track, there is at least some early evidence of that fact.

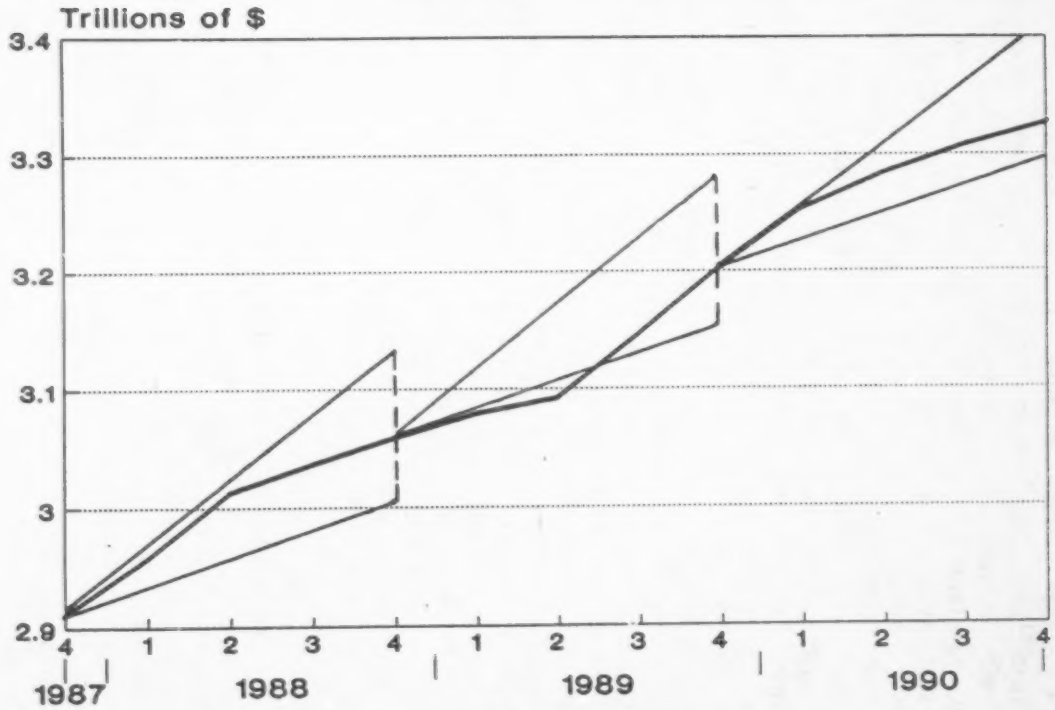
Senator HEINZ. Just to get my kind of noneconomist's 2 cents in, I think that that explanation would be more convincing or persuasive if it hadn't been for the fact that it wasn't just in the fourth quarter that M-2 lagged, but that it had been below the midpoint or even below the range at almost every point, according to the charts that have been supplied by the Congressional Research Service since the fourth quarter of 1989.

If I'm incorrect on that——

Chairman GREENSPAN. That is not correct.

Senator HEINZ. I ask unanimous consent that the chart prepared by CRS be placed in the record at this point. Please comment on it in writing if it's wrong.

FIGURE 4. M2



Source: Board of Governors of the Federal Reserve.

Chairman GREENSPAN. Sure.

The CHAIRMAN. Without objection, it's so ordered.

Senator HEINZ. My last inquiry relates to how we get out of the place we're in, which is a recession.

Chairman GREENSPAN. That's the important question.

Senator HEINZ. The really important question. And this particular chart shows that, for 1990, the most obvious underperformer, and I know you can't see it from there, has not been consumption, it has not been net exports, and it has certainly not been government, with the kind of deficit that we've been running. But it has been investment. Investment has been lagging, according to this analysis prepared by the U.S. Department of Commerce, as a source of GNP growth.

If that is an oversimplified, but nonetheless, valid generalization, I'm wondering if it wouldn't be appropriate for Congress, because savings translate to investment, to focus as a very high priority matter on incentives to create savings.

As a personal matter, I strongly believe that that's what Congress should be doing. I am in the process of developing and plan to introduce a super-IRA that, in addition to the normal features of an expanded individual retirement account, which includes withdrawing for catastrophic medical expenses and those other so-called super provisions—first-time homeownership and the like—it would provide an additional incentive within an account in the IRA for investment in equity securities as a means of getting at the problem, first, of insufficient savings and investment, and second, the high cost of capital that is generally associated as a problem in directing savings toward productive investment in this country.

Of course, as you know, the Federal Reserve of NewYork had that all-day seminar that Mr. Corrigan and his staff hosted. If nothing else was agreed upon, and it is very difficult to get economists to agree on anything, there was agreement that the cost of equity capital remained a disproportionate problem for the United States of America relative to all our trading competitors.

My question to you is do you believe it would be desirable in the context of any new individual retirement account proposal, and they are abounding on the Democratic side of the aisle, they're abounding on the Republican side of the aisle, would it be desirable to have a special extra incentive for directing some of the investment that we would anticipate—I should say savings—in those IRA's toward equity types of investments, not just any kind of investment?

Chairman GREENSPAN. Senator, my initial response would be positive on that. But I must tell you that it is a rather complex issue and I would prefer to give it somewhat more thought.

But there's no question that you're raising the most important question relevant to the long-term economic strength of this country which is basically saving and the equity cost of capital, which is directly related to that. And if we can find a means to resolve this or even improve it even modestly, there's no question that it would be a very positive thing to have done.

Senator HEINZ. Thank you, Mr. Chairman.

The CHAIRMAN. If I may, as a follow-on to that, I'm going to ask you to have your staff do a piece of work for us because I'm interested in this as well.

Japan had five times the amount of equity capital investment in their country in 1989, the last year for which I have the data, than we did in the United States. It's part of this growing global gap that we have.

I'd be interested in a study that shows what happens when you chip off, say, 2 percentage points of consumption. If people put it into a savings account, and it presumably makes its way out in terms of capital investment in some form, how much does that start to change the economy?

What are the other implications on the consumer side?

Chairman GREENSPAN. I think that's precisely what the issue is and that's the type of thing which I think really relates also to Senator Heinz's point.

The CHAIRMAN. Well, that's my point. I would appreciate it if somebody could take a look at that and give us a way of analyzing what you gain and what the offsets are, if you can manage to do that.

Chairman GREENSPAN. We'll endeavor to do that.

The CHAIRMAN. We'll finish here shortly. You've been very patient. And I want to be very blunt about this and I hope you'll give me as direct an answer as you can.

Aren't the banks today in a position to bring the prime rate down below 9 percent? And shouldn't they be doing so?

Chairman GREENSPAN. It's fairly apparent from looking at the spread between the prime rates, on the one hand, and Federal funds and CD's, on the other, the two major sources of short-term financing, that the gap is much wider than it usually is historically.

What this is, of course, is a sympton of the credit crunch. There is a grave concern about lending for fear of undercutting the capital position of the bank. And the simplest way to avoid lending is to ration it by keeping rates unduly high.

The CHAIRMAN. Too high.

Chairman GREENSPAN. So if one is saying on the basis of past experience, is the prime higher than it would be under normal conditions relative to the cost of funds to the bank, and I emphasize, normal conditions, the answer is yes it is.

Does that suggest that there are not other reasons why the prime has opened up against the cost of funds? The answer is, obviously, it's one of the elements involved in this whole process which we're trying to address in as sensible a manner as we can.

The CHAIRMAN. Well, but to use the phrase that you just used, and I think it's a good one—credit rationing—in effect, you can get a kind of credit rationing by keeping the prime at a higher rate than it otherwise should be.

Chairman GREENSPAN. That's what the credit crunch is. It's a form of rationing.

The CHAIRMAN. And that's happening today.

Chairman GREENSPAN. Sure.

The CHAIRMAN. Don't you have some leverage, even if it's a jawboning leverage, if the banks ought to be adjusting the prime downward to help get the economy to stop the fall and to level out?

Chairman GREENSPAN. We have to be a little careful, Mr. Chairman, because remember what we are dealing with is a number of banks which have seen a dramatic rise in nonperforming loans. And while one may argue, and I might, that there is undue concern on the part of a lot of the banks, there also should be some concern and conservatism relative to some of the actions they've taken in the mid-1980's, which I think is appropriate.

So I'm not at this stage going to argue in each and every case that those individual bankers who have held the prime higher than it would otherwise be, are acting inappropriately.

I think it is up to us to find means to reduce the risks involved in this process in a manner which will make them feel comfortable in lowering the margins that they are now engaged in relevant to their lending practices.

The CHAIRMAN. But it might well be that if you lowered the discount rate a ½ point, that the prime would stay right where it is.

I don't think that's good national economic policy. I think the banks have to be working with everybody else. That isn't to say that they ought to be making bad loans. Clearly, they shouldn't. But when you've dropped the borrowing rate to them by 2 percentage points and they've passed on essentially only 1 percentage point to the borrowers, there's something amiss here.

Chairman GREENSPAN. I would point out that the last time we reduced the discount rate, they followed us basis point to basis point.

The CHAIRMAN. But you concede, I'm sure, the point that you've still moved down much further than they have.

Chairman GREENSPAN. That's correct.

The CHAIRMAN. And they're in effect keeping the difference. Now I understand why they would like to do that, but I must tell you I'm troubled when the view of the Fed is, the Fed governors, which I assume includes yourself, and the district officials, as I quoted out of your own report here, that in the near-term, the risk to the economy may be skewed to the downside.

I don't think we ought to stay in a downward sloping position. I think it's sound national policy, given all the other structural weaknesses that we see out there, to level this thing out. I think everybody has a part to play.

And when you're easing the cost of funds to banks, I think within reasonable bounds, they have some obligation to not engage in a kind of credit strangulation that doesn't just cut off unwise credit, but cuts off necessary credit to good borrowers that the economy needs.

And we're hearing a lot of that. We were hearing it 8 months ago. That's why we had this discussion 8 months ago. We're hearing even more of it today.

So don't they have some obligation here to try to respond within some reasonable range to help bottom this thing out?

Chairman GREENSPAN. Many of the banks—in my judgment, the vast majority of them—act quite responsibly, and when they don't

respond to market forces directly, there usually are reasons why they do not.

Going back, incidentally, for a minute to the discussion we had 8 months ago, it's important, especially in this context, to recognize that the early stages of what turned out to be the credit crunch were actually healthy for the system.

Our view is that we welcomed the moving back from what was clearly a lax lending practice pattern of the banks, and that it was not until July when we concluded that they had moved over the line from the healthy restoration of conservative practices to what we now call the credit crunch.

And it has been since then that we have become increasingly concerned about this particular phenomenon. I should hope that it will get resolved sooner rather than later, but get resolved it will.

The CHAIRMAN. Well, the question is how many businesses out in the country and how many people that work for those companies who are losing their jobs as the businesses shut down and lay off people or go out of business, will not survive the credit crunch?

It's the question of who gets to the other side? Who makes it through this thing?

I think we're seeing a certain cascading effect. I'm not saying that it's a freefall, although you heard Mr. Larson on the RTC board's view on the decline in real estate values when you were in here within the last 30 days.

Chairman GREENSPAN. I think I did respond then. I agreed with his direction, but I thought the choice of words did not capture actually what I thought was going on in the markets.

The CHAIRMAN. I understand. But it's an illustration of the fact that there's a legitimate difference of opinion and you have highly skilled observers and practitioners at the highest level who look at the data and see it differently.

But I guess the concern that I want to finish by expressing here is that I think there is a damage accumulating out there. It's very difficult to stop. I'm not suggesting in any way you have a magic wand to wave to be able to stave it off.

But I think on the margin, the policy adjustments are very important. And the signals that they send and the way that they impact psychology is very important.

I think we're accumulating a damage level here that is very worrisome to me. And I'm seeing it in the manufacturing sector. I'm seeing it in supplier companies in the manufacturing sector who are calling me and saying that, they're good for another 30 days or they're good for another 60 days.

I'm talking about businesses that employ lots and lots of people, and have been around for years and years.

That may sound anecdotal, and it is anecdotal, but that's real time information.

Chairman GREENSPAN. Anecdotes are facts.

The CHAIRMAN. They're coming through the door. I would hope that you can find a way to get M-2 back within your range through whatever means necessary, that we can accelerate this discussion among the regulators on how we make intelligent adjustments in that process—which I gather is coming down the home stretch, or that there might be some ability to take interest rates

down either by your direct action or by the prime coming down. I think all of these things working in some combination to break the fall of the economy are things that we have to try to inject into the policy mix here.

No one knows how this war is going to go or what the reactions will be even when it comes to an end in terms of consumer confidence. I'm struck by your statement that you say that within your memory, you can't recall an occasion where consumer confidence has taken the degree of plunge that we have seen here. You said that just a short time ago here today.

That's significant. I mean, that's based on something. That's not just one or two stories; that's a composite of public opinion based on everything that people are sensing and experiencing and assimilating into their judgment.

So something is out of kilter out there and we touched on a lot of the subjects, but I'm not sure yet that we've gotten a policy mix in place that is interdicting this problem to level it out fast enough.

It may well be, if we were wise enough to know, that some of the things we might like to have as policy tools maybe we don't have right now, or maybe doing something differently 5 years ago or 2 years ago or 10 years ago was what we really needed, but that's not available to us now.

I would be hopeful that we would be finding ways to make certain that we've leveled this recession out and that we not continue to see unemployment climb and the other cumulative negative effects in terms of business failures and extreme credit shortages in areas of the economy that I think are hurting us.

I know you'll do the best you can with it, and I appreciate your testimony today.

Chairman GREENSPAN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Chairman.

The committee stands in recess.

[Whereupon, at 12:47 p.m., the committee was recessed.]

[Response to written questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

Alan Greenspan

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

April 5, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am responding to your letter of March 5 in which you asked a number of follow-up questions to my testimony before the Committee on the Federal Reserve's Monetary Policy Report to the Congress on February 20, 1991.

The answers to your questions are presented in the enclosure. Please let us know of we can be of further assistance.

Sincerely,

Enclosure

Q.1. Other than looking at surveys of lending practices, can you quantify in any way the size or impact of the credit crunch? I'm most concerned about an apparent decreased willingness or ability of banks to lend, rather than credit restraints reflecting increased lending risks during a recession and falling real estate prices or a decrease in credit demand, and about the extent to which banks' curtailment of credit is not offset by other lenders.

A.1. It is not possible to quantify with any confidence the effects of reduced bank willingness to lend. The issue is complicated by the necessity, recognized in your question, of abstracting from the effects of the general macroeconomic situation on lenders and borrowers.

Nevertheless, a number of quantitative indicators do seem to point to a reduction of bank credit availability. For example, the spread of the prime rate over the federal funds rate has widened over the past year or so, from around 200 basis points at year-end 1989 to about 300 basis points most recently. In addition, while information on non-price terms of lending by commercial banks is extremely limited, the available evidence and anecdotal information point to a tightening of such terms. Surveys indicate, for instance, that collateral requirements for certain types of loans have been increased.

At least partly as a result of reduced bank willingness to lend, bank credit growth has slowed, falling from 7-1/2 percent in 1989 to 5-1/2 percent in 1990. This deceleration was somewhat larger than the decline in the growth of nominal GNP and domestic nonfinancial sector debt. However, drawing inferences from these figures is difficult, because the reduction in bank willingness to lend may well have affected growth of GNP and total debt, in addition to expansion of bank credit.

The reduced availability of bank credit likely was offset to some extent by other lenders. For example, the growth rate of business loans at finance companies picked up to 12-3/4 percent last year from 10 percent in 1989. However, a number of non-bank lenders recently have experienced difficulties similar to those of commercial banks, including asset-quality problems and a related increase in their cost of funds. Partly because of these difficulties, as well as because of the lack of established relationships between some of these lenders and borrowers, it is likely that borrowers faced less favorable loan terms than they did previously at banks.

In any case, information about loan terms of non-bank lenders is extremely limited, and even data on their lending volumes is sparse. Thus, it is difficult to make inferences about the extent to which their lending offset banks' curtailment of credit.

Available quantitative measures are not adequate, by themselves, to gauge the extent of an "exogenous" credit restriction, that is, a reduction of credit availablity independent of the macroceonomic situation. But a broad range of qualitative evidence, including information on regulatory and supervisory developments as well as anecdotal information about bank lending, suggests a distinct pull-back by commercial banks. When these quantitative and qualitative indicators are taken together, an inference that reduced credit availability probably has had an adverse effect on aggregate spending and production appears warranted.

Q.2. In your testimony, you express a concern about cyclically "exaggerated appraisals" of real estate that have been used to evaluate loan collateral. And you recommend using some other basis for regulatory judgments about loan quality. But some analysts believe that over-capacity of office space will last for ten years and that we are in a real estate depression, not just a brief cyclical downturn. Is there a risk that adjusting regulatory evaluation practices will turn out to be another form of forbearance?

A.2. The clarifications and refinements recently announced by the banking and thrift regulatory agencies in connection with their joint statement on credit availability do not constitute a form of forbearance. In this statement, the agencies stress that the supervisory evaluation of real estate collateral should be based upon the ability of the asset to generate cash and income over time, given reasonable projections of rents, expenses and occupancy rates. We have tried to emphasize that the very nature of real estate and the bank lending process itself suggest that real estate collateral should not be assessed solely on the basis of immediate liquidation prices. Rather, the supervisory assessment of real estate should take into account, consistent with prudent evaluation techniques, the long-term value of what is an inherently illiquid asset.

Nothing in this approach, however, is intended to encourage, suggest or tolerate the deferral of loss recognition or delaying the timely charge-off of identified loss from a bank's balance sheet. Moreover, this approach to assessing real estate does not alter the Federal Reserve's longstanding policy that assets carried at values that exceed their stabilized, or reasonably expected, cash generating capacity should be written down in a timely manner. If such write-downs lead to inadequate capital or reserve positions, capital and reserves should be replenished in a timely manner or the organization should be subject to appropriate supervisory limitations, including restrictions on dividends and growth, until its financial health is restored.

Q.3. In your report, you note that, in real terms, the dollar has now completely reversed its rise in the early 1980s, and its level now is about the same as its low in 1980. But the non-oil portion of the trade balance in 1980 was a surplus of $54 billion, while last year it was a deficit of $46 billion. If it's not price levels, or exchange rates, or oil imports, what explains this $100 billion deterioration in our competitiveness over the last decade?

A.3. While the deficit on non-oil trade has declined significantly since its peak in 1987, it has not returned to its level in 1980. There are two principal factors that can account for this.

First, although the decline in the dollar acted to improve U.S. competitiveness and the non-oil deficit, growth of domestic demand was higher in the United States than in foreign industrial countries on average over the 1980s. This differential in real growth tended to cause U.S. imports to increase more rapidly than exports, on average. Even if U.S. and foreign demand had grown at the same rate, the deficit would have widened somewhat due to income influences. Historical experience suggests that U.S. imports have tended to grow somewhat faster in response to changes in U.S. income than exports have grown in response to changes in foreign income.

Second, at least some of the explanation has to do with the timing of the dollar's movement and the lagged response of trade prices and quantities to changes in exchange rates. The dollar appreciated virtually continuously in real terms over the first half of the 1980s. The non-oil trade balance continued to decline through 1987, reflecting the lagged adjustment of trade

prices and quantities to changes in exchange rates. The depreciation of the dollar that began in 1985 has not been continuous, however, but was interrupted by a period of strength during 1988 and the first half of 1989 that impeded the process of trade adjustment. Because trade prices and quantities continue to adjust to changes in exchange rates for about 2 years, it is unlikely that the full impact of the return of the dollar to its 1980 level had been fully realized by the end of last year.

An alternative perspective arises from recognizing that external imbalances reflect imbalances between savings and investment (as the current account is equal to savings minus investment). During the 1980s, U.S. investment rates exceeded U.S. savings rates by a wide margin, reflecting record government budget deficits and declines in the rate of private saving. Until the domestic public sector deficit narrows significantly, it is likely that this imbalance between savings and investment (and hence the current account) will continue.

Q.4. Many of the more optimistic forecasts, and possibly yours as well, seem to depend heavily on some substantial improvement in our trade balance. How realistic is such an expectation? If it comes true, would it be just a temporary recession related phenomenon or would it likely be more lasting?

A.4. Expectation for some moderate improvement in the U.S. trade position appears to be warranted based on the competitiveness of U.S. products in foreign markets and the prospects for growth abroad.

Over the next 2 or 3 years, it is reasonable to expect some further lasting improvement in the trade and current account deficits. A major factor contributing to this is the low value of the dollar relative to other major foreign currencies. The depreciation of the dollar from the middle of 1989 through January of this year should add to gains in the competitiveness of U.S. products overseas for some time to come, with most forecasting models indicating that changes in exchange rates continue to affect trade for about 8 quarters. Estimates of relative unit labor costs indicate that labor costs of production in the United States in 1990 were roughly 30 percent below those in foreign industrial countries.

In addition, growth in industrial and developing countries is expected to reinforce the effects of the dollar. Despite recessions in Canada and the United Kingdom, and weak growth in several other European economies at the end of last year that is estimated to have continued into the early months of this year, it is widely expected that by the end of 1991 real economic growth will return to a healthy pace in our major trading partners. The effect of the rebound in economic activity in foreign industrial countries on U.S. exports will likely be enhanced by the rebuilding of Kuwait in the aftermath of the Iraqi occupation and, over time, by the opening of markets in Eastern Europe.

Q.5. Housing costs in the CPI continue to rise, even as house prices and mortgage rates tumble. Is there something wrong with the way the CPI estimates these costs?

A.5. I would offer a couple of comments in response to your question; of course, the Bureau of Labor Statistics, which produces the CPI, would be able to respond in the greatest depth and you may want to pursue the issue with them.

My first comment is that housing costs in the CPI encompass more than the expense associated with purchasing a single family home. For example, maintenance and repairs costs are part of the CPI "housing" subindex.

Second, in recent years, the BLS has employed a different concept in pricing owner-occupied housing, which has made the linkage much less direct to house prices, per se, and mortgage rates. You will recall that, a decade ago, many analysts criticized the treatment then of housing, which did involve a combination of house prices and interest rates; it was widely believed that, at that time, the CPI was overstating the increases in the cost of living. The BLS switched to the concept of "owners' equivalent rent," which uses a sample of rented homes as a basis for evaluating the effective cost of living in owner-occupied dwellings. This change has considerable virtue analytically, but it does present some knotty measurement problems--and it certainly has given rise in the past year to questions of the sort you have raised. Owners' equivalent rents and house prices can reasonably be expected to be broadly correlated over the longer run, but for any short period it is quite conceivable that the two series might diverge.

I should mention as an important aside that, while house prices clearly have fallen in some locales, in some others they have increased. To a considerable degree, what we have witnessed is some reversal of wide regional disparities in house prices that developed during the 1980s, and on average the picture is not quite so bleak as some commentary might lead one to believe.

Q.6 What are the prospects for the hardest hit regions of the country, New England and the Southwest?

A.6. All regions of the country should benefit from the upturn in aggregate economic activity that is anticipated to begin in the months ahead. Clearly, performance will differ regionally, and the rebound in the New England area in particular may be less vibrant initially than in many other regions, in part because of the relatively sizable overhang of real estate and the reverses experienced recently by financial institutions there. The process of adjustment to similar problems in the Southwest--especially in the oil patch--is more advanced than in New England, and that region should participate in the cyclical upturn unless there is another collapse in oil prices.

Q.7. Last year, Comptroller General Bowsher reported to Congress a listing of 14 high-risk areas where the General Accounting Office had identified potentially serious management and other problems that could result in significant financial losses. On February 7th of this year, he wrote me announcing the addition of two new areas to GAO's high risk list. In that letter, he stated:

"The continued deterioration of the commercial banking industry has heightened our concern that the Bank Insurance Fund may soon run out of resources. Further, we have evidence that the banks lack effective controls over their operations and that accounting is masking their true condition. These elements combine to pose a risk of a taxpayer bailout."

To what extent, in your opinion, do "banks lack effective controls over their operations," and to what extent are current accounting practices masking their true condition?

A.7. Credit losses are the main cause of serious bank financial problems that may lead to bank failures. In a number of cases, banks experiencing serious financial problems have failed to maintain effective

controls over some aspects of their operations, including their exposure to credit risk. In other cases, local or regional economic conditions have been major contributing factors to credit losses.

It is a principal function of bank management to establish and maintain effective internal controls over bank operations. At the same time, the banking agencies, including the Federal Reserve, endeavor to promote effective internal systems and controls during on-site examinations. For example, during examinations of state member banks, Federal Reserve examiners check carefully to determine that banks have appropriate operating policies and effective internal control systems. The Federal Reserve expects all banks to have an effective audit function and specifies that an important element of this function, whether performed by external or internal auditors, is to review the organization's operating policies and to determine that internal controls are adequate. Furthermore, as part of the examination process, examiners discuss with bank management the recommendations arising from the bank's audit function and the regulatory examination process to determine if they have been fully and properly addressed. Failure to address adequately internal control deficiencies would lead to formal enforcement action against the bank.

The second part of your question expresses the concern that current accounting practices could mask the true condition of banks. Generally accepted accounting principles (GAAP) must be followed in the preparation of financial statements filed with the Securities and Exchange Commission (SEC) or that are otherwise audited by Certified Public Accountants (CPAs). State member banks are required to prepare their regulatory Reports of Condition and Income (Call Reports) in accordance with reporting requirements established by the Federal Financial Institutions Examination Council (FFIEC), which are generally consistent with GAAP. In those few instances where the Call Report specifies reporting requirements which differ from GAAP, these requirements are intended to be more conservative than GAAP.

In general, we believe that GAAP provides an appropriate framework for the accurate reflection of a bank's financial condition. At the same time, an accounting system can only be effective if losses and other declines in asset value are recorded in a timely and accurate manner. Thus, it is incumbent upon bank management to ensure that it has in place policies and procedures that provide for the timely recognition of loan problems and credit losses through appropriate

charges against earnings, and adjustments to loan loss reserves and capital positions. It is equally important that the frequency of on-site examinations permit bank supervisors and examiners to thoroughly review the adequacy of loan loss reserves and capital in a timely manner. It is for this reason that the Federal Reserve conducts annual on-site examinations and supports this policy as part of a framework of prompt corrective action.

Reliance on GAAP is not meant to suggest that improvements and refinements should never be made in accounting principles. Indeed, the Financial Accounting Standards Board (FASB) and the American Institute of CPAs (AICPA) have a number of projects underway to determine ways to improve the FASB and AICPA standards that form the authoritative basis for GAAP. The Federal Reserve and the other Federal banking agencies are supporting these efforts through participation in advisory task forces and by providing comments on proposals published for comment. Furthermore, the Federal Reserve and the other Federal banking agencies, under the auspices of the FFIEC, are also undertaking a number of projects to improve the supervisory guidance and reporting requirements that banks must follow when preparing Call Reports.

Q.8. Please provide an analysis of what the effects would be of increasing the personal savings rates by 2 percentage points over the next decade or two. How would our economic growth rate be affected, and how would consumption be affected, on balance? How much would the present value of our future consumption over that period increase or decrease?

A.8. I wish I could give you a simple, straightforward response, but, as with many economic questions, the answer depends on a large number of assumptions--assumptions that legitimately could be varied enough to alter the quantitative result appreciably. In this instance, one key assumption would be about the degree to which the increase in <u>personal</u> saving would be reflected in increased <u>national</u> saving, this being important in gauging how much capital formation, and thus potential output in the economy, would be increased. If, for example, the increased personal saving were to result from enhanced tax incentives, which tended to expand the budget deficit, the outcome might be different from that which would be obtained if the greater saving arose, say, from a demographic shift.

That said, I think it would be reasonable to expect that an increase in personal saving that did translate into increased national saving would result in great potential output over time and yield a positive increment to the present value of future consumption. This may seem to be stating the obvious, but economic theory indicates that it is possible to have too much saving, in the sense that the capital stock can be enlarged to the point that so many resources are absorbed in maintaining that stock over time that the present value of consumption is reduced. It is my judgment that this is not likely to be the case in the present circumstances.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 2, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

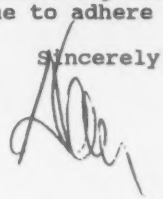
Recently, I provided written responses to questions you sent in a follow-up to the February 20, 1991, Banking Committee hearing at which I testified. Among the questions raised was one regarding the economic consequences of a decline in the proportion of income that is consumed. I noted that the estimation of that effect is problematic, and that any calculation would be contingent on a variety of conditioning assumptions and still highly uncertain. In subsequent contacts between our staffs, it was indicated that you would like to have some quantification, even with these caveats.

The attached note, prepared by the Board staff endeavors to supply an answer to your question. As you will see, the result the staff has arrived at indicates that a two percent increase in the saving rate would yield, through its effects on the size of the capital stock, a significant gain over time in potential output and in consumers' living standards. I would underscore one important point of uncertainty, especially as one looks ahead at a world in which capital markets likely will become even more integrated internationally--that point being that additional U.S. saving could flow abroad to some degree, resulting in a lesser increment to domestic capital formation. This is not to say that U.S. households would not benefit in terms of their wealth and scope for increased consumption: They would derive income from investments abroad and, with that income, would be able to purchase additional goods produced elsewhere.

There are other complexities as well, and the actual effects could be larger or smaller than the point-estimate in the staff note; however, I feel confident that the direction of the effect can be predicted with reasonable assurance. The policy question is what the most effective way is of elevating national

saving, and as I've indicated on numerous occasions, I believe that the focus should be on reducing the federal budget--and that the most certain way of accomplishing this permanently is by restraining spending. The budget system put in place last year holds great promise for achieving that objective, and I hope that the Congress will continue to adhere to the program.

Sincerely,



Long-run Effects of Increases in the National Saving Rate

This memo provides rough estimates of the long-run increase in per capita real consumption resulting from an exogenous 2 percentage point rise in the U.S. national saving rate. Based on assumptions described below, the equilibrium increase in per capita consumption would be 7 percent, or about $1000 (1982 dollars) per year evaluated at the current value of consumption.[1] Estimates of the change in the present value of the consumption stream also are presented. These estimates help to assess whether the initial loss in consumption (due to the higher saving rate) is outweighed by the subsequent gain and suggest that the discounted value of the consumption stream rises by about 2 percent. To keep the analysis tractable, it is assumed that the rise in the national saving rate immediately passes through point-for-point to the ratio of domestic net investment to GNP; certainly some of this incremental saving might instead flow abroad, but this possibility (along with all other open-economy issues) is ignored. Also, the effects of the higher saving rate on the short-run cyclical behavior of the economy are not addressed.

The basic rationale behind the result that higher domestic saving and net investment rates in the near term generate increases in future per capita consumption is straightforward. Higher net investment rates lead to a larger stock of capital per worker which, given a standard production technology, translates into higher output per worker; this gain in labor productivity eventually provides the resources that support greater consumption per capita. Of course, because of diminishing marginal returns to capital formation there is a limit to how much consumption per capita can be increased.[2]

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[1]For this analysis, consumption is defined to include government purchases. Also, the results do not depend on whether the increase in national saving is caused by greater household, business, or government saving.

[2]That is, as the capital stock increases, the increment to output per worker declines while the required level of output per worker that must be devoted to investment rises at a constant rate (in order to replace the greater amount of depreciated capital and maintain the new capital-labor ratio in the face of a growing labor force); eventually the level of consumption per worker (or per capita) reaches its maximum or "golden-rule" level. The maximum level of consumption per capita should not be confused with the optimal level; the latter is less than the former to the extent that society discounts future consumption and, thus, is prepared to sacrifice some feasible future consumption in order to consume more in the present. In addition to shedding little light on the issue of optimal consumption, the

This notion that a country can increase its level of saving and investment by too much may seem irrelevant for the United States whose level of nominal net investment as a percent of GNP--about a 5 percent average in the 1980s--is low by historical standards. However, the Omnibus Budget Reconciliation Act of 1990 sets the federal budget deficit on a downward trend over the next five years. Assuming that this projected reduction in federal government dissaving in fact increases national saving and investment, the impact of a subsequent exogenous increase in the saving rate on long-run consumption would be diminished. For the sake of the calculations here, the projected fall in the budget deficit is ignored and the increase in the net investment ratio is calculated relative to a baseline in which its 1980s value persists indefinitely.

Under these assumptions, the 2 percentage point increase in the net investment ratio is equal to a sustained 40 percent increase relative to its 1980s baseline value. This, in turn, will yield ultimately an equivalent percentage rise in the capital-output ratio. Given a standard production relationship, the elasticity of gross output per worker with respect to the capital-output ratio is about 0.4, and, thus, real output per worker increases by 16 percent or over $6000 per year when the increase is evaluated at current levels of real GNP and the workforce.[3]

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analysis does not provide a basis for determining a desirable investment strategy in response to the demographic bulge caused by the baby boom of the 1950s. We estimate the golden-rule level of net investment (I*) to be between 8 and 9 percent of GNP in the United States. This assumes a Cobb-Douglas production technology with capital's share of output (a) equal to 30 percent; the depreciation rate of capital (d) equal to 6 percent per year; and the steady-state growth rate of output (g) equal to 2.5 percent per year. The formula used is $I^*/GNP = ag/(g+d)$.

[3]The elasticity estimate of 0.4 is based on the venerable Cobb-Douglas production function; this function implies that, under competitive input pricing, the shares of gross output going to capital and labor are constant, an observed characteristic of our economy over long periods of time. The elasticity is equal to the ratio of these income shares which are roughly 30 percent for capital and 70 percent for labor. The 0.4 value of the elasticity assumed in the calculations is crucial to the results; a smaller value would reduce the long-run gain in labor productivity and, hence, consumption possibilities. Another issue regarding the assumed production technology is that a small fraction of GNP, including government output, is defined in such a way that it is invariant to the stock of capital. If we assumed that the Cobb-Douglas technology applied only to the narrower definition of output that excluded these sectors, the effects of higher net investment on total output and consumption would be reduced a bit.

To reach conclusions about output available for private or public consumption, the increase in net investment per worker must be subtracted from the increase in output (net of depreciation) per worker. Because the real net investment-output ratio is initially assumed to rise by 40 percent and because the gross output-worker ratio rises by 16 percent, it follows that real net investment per worker rises by 56 percent or roughly $1000 per year evaluated at current levels. Moreover, assuming that real depreciation of capital is proportional to the existing stock (and thus proportional to net investment in the long run) implies that real depreciation per worker also rises by 56 percent or about $3000 per year evaluated at current levels. Thus, total real consumption per worker rises in the new long-run equilibrium by over $2000 per year or roughly 7 percent of its current value; total real consumption per capita rises by over $1000 per year or 7 percent of its current value.

Thus far, the analysis has been in terms of the long-run effects on consumption. A calculation that perhaps is more relevant is the change in the present value of consumption. A simulation model designed to capture the salient elements of the previous analysis shows that, because the capital stock and output respond only gradually to the higher net investment rate, consumption is reduced for the first 14 years but is higher thereafter. Taking this into account and assuming a real discount rate of 3 percent per annum, the present value of consumption per worker over the next 100 years, associated with the path of higher net investment, is about 2 percent higher than in the baseline case.

As a final point, it is useful to reiterate that the analysis has been carried out in the framework of a closed economy. The effects on U.S. GNP and consumption would more than likely be diminished if cross-border flows in saving were accounted for. Just as the effects on domestic investment of the budget deficits of the 1980s appear to have been dampened by an inflow of saving from abroad, a rebound in national saving might result in a partially offsetting net capital outflow.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM
Alan Greenspan

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

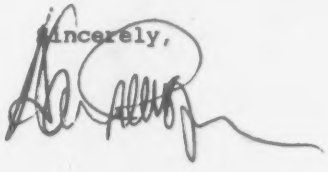
May 13, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are answers to questions from Senator Sanford following the Senate Banking Committee's February hearing on our First Monetary Policy Report for 1991. I regret the delay in responding, but hope the answers will be useful to your Committee.

Sincerely,



Q.1. As you know, the director of the Congressional Budget Office recently testified that the Bank Insurance Fund will be insolvent by the middle of 1992. Various groups are working to pull together a plan to pump $10 billion or perhaps $12 billion into that fund.

I am concerned that it appears that we may be starting down the same road that we went down with the S&L industry. We debated at some length whether the amount added in CEBA through borrowings paid for by the thrifts should be $7 billion or $15 billion, which turned out to be totally irrelevant.

Now, we are looking at similar plans to borrow money to shore up the FDIC, paid for through special assessments on the banks or similar mechanisms. We are only looking at how to make more funds available to the FDIC so they can move more quickly in closing a bank and paying off the depositors. We almost accept it as inevitable that these banks are going to fail and we will have to bail them out.

I don't want to go along with that concept if we can find a better way.

As such, I have proposed that we create an Emergency Bank Investment Corporation, modeled in part on the Reconstruction Finance Corporation from the 1930s. Others have suggested similar approaches, using either Federal Reserve funds or borrowings by the FDIC to invest in marginally capitalized banks. These investments could be conditioned on mergers, consolidations or other changes that would ultimately result in a safer and sounder bank.

What do you think of these ideas?

A.1. As you note, a number of suggestions have been made recently to use government funds, from the Federal Reserve among other sources, to recapitalize banks. The motivations for such suggestions are easy to understand: Poorly capitalized banks have cut back on lending to businesses and other borrowers, contributing to the weak economy; in addition, the condition of banks with inadequate capital often tends to deteriorate further, and these banks may be less costly to deal with while they are still going enterprises than after they come under the control of the FDIC.

For these reasons, such suggestions merit careful consideration. There are good reasons for caution, however, when assessing any proposal that increases the role of the government in the credit markets. Such activity is not without its potential costs. Taxpayers are subject to the risk of default on the investments made, and support by the government of one class of borrowers tends to raise the cost of credit for other, competing, uses. In addition, once initiated, such programs are difficult to terminate even after they have outlived their usefulness.

I was pleased to see the emphasis in your approach on conditioning any capital infusion on consolidation of banks or changes in their managements or business strategies. It is crucial that any government funds not be used to forestall the needed consolidation and restructuring of the banking system.

Q.2. As I mentioned in my opening statement, I am very concerned about the credit crunch we are experiencing and about its implications for the banking system.

As you know, the Treasury Department recently released its long-awaited report on modernizing our financial services system. As I read it, the major change the Treasury recommends to bring more capital into the banking system is to remove the current barriers between financial firms and industrial companies.

Do you agree that industrial firms should be permitted to own banks?

If the Congress is not willing to take that step, do you think we need to take other steps to bring more capital into the banking system?

If so, what steps would you suggest?

A.2. The Board believes that, in principle, any corporation should have the right to go into any business--including banking, with the proper safeguards. However, the Treasury is also proposing a series of other reforms that cumulate to a fundamental change in our banking and financial system. It might be best to gain more experience with wider financial ownership of, and wider activities for, banking organizations by the Treasury before we enact this difficult-to-reverse linkage between commerce and banking, especially since a strong case for immediate enactment has not been made.

In the Board's view, the way to attract capital into the banking system is to provide more profitable opportunities for banking organizations and to eliminate unnecessary constraints on the effective operations of banks. An end to the McFadden Act restrictions on interstate branching and the authorization of all financial and agency activities for holding companies with well-capitalized bank subsidiaries would accomplish those ends.

Q.3. As a general proposition, do you believe we need more capital in the banking system?

A.3. An adequate capital cushion is critical to maintaining the safety and soundness of individual banks and protecting the deposit insurance fund from excessive losses. A significant commitment of capital from owner-shareholders also ensures that these individuals will have strong incentives to oversee and control the risk-taking activities of bank managers.

The Federal Reserve is in the process of phasing-in risk-based capital standards and, in fact, the overwhelming majority of U.S. banking organizations already meet the end of 1992 minimum ratios. We believe that in the long-run banking organizations should maintain capital ratios well above these minimum standards and that, in particular, the authorization of new powers should be limited to strong, highly capitalized banking institutions.

We recognize at the present time that the earnings and asset quality problems facing some of our banking organizations will complicate their ability to raise capital. Thus, it seems reasonable that for some institutions increasing capital ratios will require a transition period and reasonable phase-in arrangements before higher levels of capital can be attained. During the phase-in period, organizations with capital deficiencies or asset quality problems will be monitored closely to assure that they do not embark on aggressive expansion activities or engage in other imprudent activities.

Whether higher capital ratios will lead to an increase in the dollar volume of capital in the industry is a difficult question. In some situations, mergers and acquisitions involving highly capitalized banks, as well as other types of balance sheet restructurings, will produce institutions with higher capital ratios without

bringing more capital into the industry as a whole. In other cases, raising capital ratios will bring additional capital into the industry. The net effect will depend on the future size and structure of the U.S. banking system.

In any event, our principal objective is to ensure that individual institutions have sufficient capital in relation to their risk assets in order to promote the safety of the U.S. banking system and to protect the interests of U.S. taxpayers.

Q.4. You have talked about the credit crunch and the reluctance of banks to continue lending. A number of items are being discussed to encourage additional lending focus on accounting changes or in the lowering of interest rates.

Do you believe these items are sufficient to encourage banks to begin lending again? If not, what else should we be doing?

A.4. The accounting and supervisory changes announced recently are an attempt to modify practices that may be discouraging the flow of funds from banks to creditworthy borrowers. Because supervisory policies and accounting practices are not the principal cause of the constriction of credit supplies, these changes are not, by themselves, expected to have a major effect, but they may help to foster some additional lending by banks and thrifts.

Lower interest rates in money markets and reduced reserve requirements should play an important role in stimulating lending. To the extent lower funding costs are passed on to borrowers, they will bolster the demand for loans. To the extent they are absorbed in bank profit margins, these lenders should be encouraged to extend more credit. Taken together, increased lending at depositories, along with the effects of lower interest rates operating through a variety of other markets, and additional forces discussed in my testimony, are expected to turn the economy from contraction to expansion. Once there is a sense that the momentum of the economy is shifting, the confidence of borrowers and lenders should be bolstered, further helping to overcome the current reluctance both to take on debt and to extend it.

Although the actions taken by the Federal Reserve in monetary policy and by all the agencies regulating depositories may well be sufficient to foster an adequate supply of credit to fuel economic recovery, we recognize the risks that they may not be enough. To the extent additional supervisory impediments to sound lending practices are identified, we will continue to work with the other agencies on appropriate remedies. More generally, we will be keeping a careful watch on money and credit growth in carrying out monetary policy.

Q.5. In many of the economic predictions we have looked at, economists give one scenario if there is a "short" war, and another if there is a "long" war. Many of these initial analyses defined "short" war as less than a month. Since we are not past that month time frame, should we now redefine "short" war or have we already begun to experience the implications of a "long" war?

A.5. At this stage, it is no longer necessary to speculate about the length of the war. The combined air and ground was brought to a successful conclusion in just over 40 days. With respect to its economic consequences, the war in the Persian Gulf is almost certain to fall into most analysts' "short" war scenarios. In terms of the net budgetary effect of the war, current estimates suggest that a substantial part of the incremental expense ultimately will be paid by other nations, cushioning the effect on the budget deficit. Moreover, these expenditures will involve on-time outlays, with only minimal consequences for the thrust of longer term fiscal policy.

THE CONDITION OF THE BANKING INDUSTRY AND ITS BROADER ECONOMIC IMPLICATIONS

THURSDAY, FEBRUARY 21, 1991

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. Let me welcome all of those in attendance this morning.

We have three very important witnesses that will be appearing today. Our hearing this morning will center on the condition of the banking industry and its broader economic implications.

In a sense, it is a follow on to some of the discussion with Fed Chairman Greenspan yesterday.

We are fortunate to have as witnesses two highly regarded bank analysts Carole Berger of C.J. Lawrence, and William Weiant of the First Boston Corp. We also have James Grant, editor of the engaging and informative Grant's Interest Rate Observer.

The health of the banking industry, of course, is of critical interest to this committee. Although banks' share of credit to U.S. borrowers has declined over the years, it is still about one-quarter of the total outstanding. And banks are, of course, an essential source of funding for many borrowers.

The committee's attention is heightened because of concerns that, as the ultimate insurers of bank deposits the public bears the risk of any losses that accumulate beyond the industry's capacity to absorb them. The recent record in that regard is not an encouraging one.

Although most banks have been and remain profitable and well capitalized, the pace of loan writeoffs and bank failures has accelerated sharply in recent years. This appears to reflect an increase in the riskiness of bank activities and, of course, it may also speak to some underlying economic circumstances as well.

The safest corporate borrowers have generally left banks, borrowing instead directly in the capital markets. Technological changes have given banks tougher competition from nonbank financial institutions and from each other as well.

Too many of the risks taken by banks in recent years have not turned out well. This year we may be faced with a need to recapi-

talize the Bank Insurance Fund, and I say "may." I don't think there is a question about the ultimate need to recapitalize it, but I think the question is really one of timing. And we will be very interested in our witness' view about how large a need that fund currently has.

Our course of action may also depend on whether we view the problem as a temporary need or a deficiency that is likely to grow over time. The industry's current problems are also of critical interest because of their effects on the economy.

In fact, yesterday Alan Greenspan told us that banks' reluctance or inability to lend is a principal contributor to the current recession and is greatly complicating the Fed's monetary policy decisions.

Today's witnesses represent neither the banking industry nor the regulators. And so they should be able to give us a kind of arm's length perspective of well informed observers and people who, I think, bring a form of expert opinion to us.

Let me invite them to come on up and sit at the table. And, as you take your seats, let me say that we are pleased to have you.

I am going to call on Senator Garn for any comments he wishes to make.

Senator GARN. Thank you, Mr. Chairman. I apologize for being a little bit late, but I'm sure you would want me to be where I was, in the Rules Committee voting on the Banking Committee's budget.

The CHAIRMAN. Thank you.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Today the committee is hearing from three expert witnesses on the condition of the banking system. This is simply not an academic question. The committee has already heard from the FDIC, GAO, CBO, and from Treasury. It is clear that banks are suffering from more losses on bad loans than at any other time in the past 50 years.

The FDIC predicts that as many as 230 additional banks will fail this year on top of the 169 that failed in 1990. Some experts indicate that over 1,000 banks with $400 billion in assets may be vulnerable in the future.

Problems exist in nonperforming commercial real estate loans, loans to finance highly leveraged transactions, and international loans to lesser developed countries. To a large extent these problems result from some basic flaws in our banking laws.

Beginning in the late 1970's, the marketplace developed new products that directly competed with commercial banks for their best customers. However, these competitors are not shackled by 60 year old laws that inhibit and, in some cases, prevent efficient competition. The result, many banks lost their prime customers.

In order to earn a profit and attract capital, banks were forced to compete for the more speculative lending opportunities. As many banks' lending portfolios became riskier, these banks became more vulnerable to economic downturns in particular markets or geographic sectors of the country. The end result is the bank failures we are seeing today.

The solution is to take an honest look at the problem in the banking industry and its root causes and to make the necessary changes in our financial institution laws, as I said yesterday. We have got to get away from the bandaids and the tourniquets and recognize the realities of the structural needs within the system and pass comprehensive banking legislation.

Certainly, this hearing today will provide the committee with a good opportunity for the testimony you bring to us, your expertise and, hopefully, to advance this process.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Garn.

I want to say to our witnesses, I appreciate your being here and the time and the effort that it takes to prepare the statements that you are prepared to share with us and your willingness to respond to questions that we might have.

As we start down the track this year in deciding what changes would appear to make sense in the banking structure and the banking system, we want to try to bring to bear as much competent opinion as we can. This is an extraordinarily complex set of issues and you bring, I think, insights that can be helpful to us.

I think we'll start, Ms. Berger, with you and we'd like to have you present your statements, and we'll go on down the table here.

Ms. BERGER. Yes. Thank you.

The CHAIRMAN. Pull that right up close to you so you can be heard throughout the room.

STATEMENT OF CAROLE S. BERGER, SENIOR VICE PRESIDENT OF CJ LAWRENCE INC., NEW YORK, NY

Ms. BERGER. Mr. Chairman and members of the committee, I am pleased to be here today to talk about the current health of the banking industry and the prospects for that industry as we go forward.

As a banking analyst for the last 16 years, I have to say that it's never been boring but these last couple of years have been the most challenging of all. And I commend you for studying the problems of this industry before you consider legislation that would in any way alter it.

As a way of backdrop, I'd just like to say that all of my comments are based on C.J. Lawrence's economic forecasts, which are for an average recession. We have a more severe forecast than either the Fed or the administration. Our economists are looking for GNP to decline in real terms this year by 1½ percent with the weakness coming in the first half (down 3 percent) and a slow recovery averaging 0 percent growth in the second half.

All of my comments tend to be geared toward that kind of economic scenario and anything materially better than that would, of course, make my projections somewhat less negative and vice versa.

I think what we're seeing in the banking industry today is really the back end of a tremendous buildup of debt in the U.S. economic system over the last 10 years. Debt as a percentage of GNP for decades ran at about 140 percent. And, over the course of the 1980's,

that ballooned to 186 percent by 1990. It is the back side of that debt balloon that is creating this credit cycle for banks.

What we have seen in the last year, particularly in the last quarter, was a tremendous acceleration in the rate of deterioration in credit in all sectors, and particularly in real estate. Nonperforming loans for the 45 banks that I do equity research on deteriorated sharply last year from about 3 percent nonperforming asset ratio at yearend 1989 to 4.8 percent by yearend 1990.

That level is double the peak reached in the 1981–82 recession for these 45 banks. So clearly we are already experiencing the worst credit cycle of the last 50 years. And the real problem is, I think it's going to continue for some time. Normally the credit cycle tends to lag the underlying economics.

The largest problem that this industry has today is their commercial real estate loans. Commercial real estate loans are almost 25 percent of total bank loans. About 18 percent are commercial mortgage loans and another 7 percent are construction loans. We have never had an asset class as large as commercial real estate have serious problems.

I mean, when Latin American countries were having significant problems, LDC loans were a huge problem for a dozen large banks averaging about 12 percent of their loan portfolios. But as a system, it was less than 5 percent of total bank lending. And you can make the same kind of comments as it pertains to energy or agricultureal loans. It had serious impact on a small number of banks, but not for the system as a whole.

This is the first time the system has to deal with a credit problem this large. And to give you some idea of how much lending was done, 62 percent of all bank lending that was done since 1985 has been for commercial real estate.

The CHAIRMAN. If I may stop you for 1 minute, I think that statistic you've just given us is a very powerful one, and I have not heard it juxtaposed with the LDC lending. Senator Graham has just joined us and I would like to recap just for a second so he can cue in to what you are saying. She has just made an observation that this problem in the banking system is quite different than we've seen before, than we saw in the early 1980's. And if I've got your number down right, about 27 percent of the assets of banks today are in commercial real estate loans of one kind or another——

Ms. BERGER. 25 percent.

The CHAIRMAN. 25 percent. And that's a very high percentage.

But she then contrasted that to the LDC problem and was saying that back when that was a problem that it was perhaps as high as 12 percent of portfolio disposition in a handful of big banks, but only about 5 percent throughout the system as a whole.

So that, while we saw that as a big problem, it was pretty narrow and not so significant when it was spread across the system, as opposed to this situation.

And I'll just let you continue on from that point.

Ms. BERGER. Yes. That aggressive lending allowed real estate developers to build office buildings at a record pace. The supply of office space in the United States doubled over the decade of the

1980's. And it resulted in an oversupply of real estate in this country of massive proportions.

We started the decade of the 1980's with office vacancy rates running 3 and 4 percent. Today, that number is 20 percent.

The big buildup came in the early 1980's, but during that period of time it didn't seem to be a problem because office employment growth, people to fill up those office buildings, kept pace with the rate of construction. And it wasn't until the late 1980's, as the rate of office employment growth slowed more rapidly than building slowed, that you got this huge surge in vacancies.

The real problems starts to occur when you do get a slowdown in a local economy. As an economy slows down, real estate developers looking at a huge oversupply, particularly of office space, say: I better cut my rent in order to fill up my building. And they set off rent wars. And the rent wars become particularly virulent.

It's my understanding that in Boston and New York, effective rents are running 50 percent below where they were 18 months ago. So you see, that has a very dramatic effect on these real estate developers' ability to service their loans. And if you allow me a little poetic license, I will give you some idea of how large this problem could be.

We've stated that real estate loans are 25 percent of total bank loans. That's about 20 percent of total assets. Let's also assume that the average bank lent 75 percent of the appraised value on the property and property values go down by 50 percent—that is consistent with rents dropping by 50 percent (as rents have in Boston and New York). The way you calculate what a commercial piece of real estate is worth is to take the net present value of the cash flows that come off of that property. So if you get a 50 percent decline in rents and run that through a net present value equation, you will get more than a 50 percent decline in value.

Now if that were true on a national basis, which is not necessarily my projection, but that's what's happening in Boston and New York already, you could make the case that banks are going to have to charge off $25 out of every $75 they lent, or 33 percent of their total real estate loans over the course of this real estate cycle.

That is the equivalent of 6 or 7 percent of their total assets, which is roughly equivalent to all of their equity and reserves. So it could be a very massive problem. It also points to the role that the regulators could play in this game.

This is also an industry which, over the course of the 1980's, was capable of earning 75 basis points to 1 percent on assets every year. If the regulators require the very rapid writedown of real estate, marking it to market as they have done so far, it will cause a great deal of bank capital to be extinguished over a very short period of time.

If, however, they change the accounting policies to allow for that recognition over a longer period of time, say 5 or 10 years, it may mean all of the industry's profitability but none of their capital. It's a very important distinction whether you're charging off capital or you're eating into earnings.

If you're charging it to capital, that's when you get the overflow impact, like the Wall Street Journal article this morning about the New Hampshire banks. Banks are highly leveraged institutions. If

you have 4 or 5 percent equity to assets and you require a bank to charge off a dollar of capital, he has to take $20 or $25 out of his assets.

So if you extinguish large amounts of capital very rapidly, you don't get credit crunch, you get what I call credit implosion. You get the banks calling their good customers and saying, give us our money back.

The CHAIRMAN. And aren't they doing that? Aren't we hearing more and more cases where that's happening, at least in some regions of the country?

Ms. BERGER. In some regions of the country. I don't think it's yet widespread. Clearly the problem started in New England. And New England is actually a very good example, without getting down to the size of the banks that were in this morning's article, even if you look at the six largest New England banks, last year the regulators in late 1989 and early 1990, required the immediate writeoff of $2 billion of capital and really pushed that economy into a very serious recession. And I think it points out the role that the regulators have to play as we go forward.

There are strong geographic differences. If you look at the largest eastern banks in New York, Boston, and Chicago, 14 percent of their real estate loans are already nonperforming. The west coast has not yet seen that kind of impact, although I think it is likely to, but the nonperforming real estate loans there are only 6 percent of their real estate exposure.

Real estate is the largest problem, but unfortunately it's not the only problem that this industry has to face. With recession come other credit losses. Commercial losses are caused by the squeeze on corporate profits by either high interest rates or a slowdown in demand for their products. That's what we're seeing now.

And even in their non-LDC and their nonreal estate exposures, we've seen a doubling in nonperforming assets at those large eastern banks this last year. Business failures are rising rapidly. So what we're seeing here is a very rapid deterioration also in the commercial sector.

Historically, those losses lag the economy. If we expect the weakest part of the economy to be upon us now, you still wouldn't expect losses from that area to peak until late 1991 or until early 1992.

A similar case can be made for the consumer. The consumer is also overburdened with debt. Consumer debt as a percentage of personal income is 79 percent. That's a postwar record high. As unemployment rates rise, which, in economic terms, they have only started to do recently, consumer losses for these banks will also rise very rapidly.

And given C.J. Lawrence's forecast of a peaking in unemployment rates at about 8 percent late in 1991, you would not expect consumer losses for these banks to crest until late 1991 or early 1992.

I think that 1991 will probably be the trough in bank earnings. But I wouldn't expect a very vibrant recovery either.

This credit cycle will end like every other credit cycle does, with very aggressive easing on the part of the Federal Reserve bringing

down interest rates, spurring demand. However, I think there are as many differences this cycle as there are similarities.

The role the regulators play is very important. Again, it goes back to capital. If you extinguish capital, you are going to create the overflow which causes a much more severe downturn which, in and of itself, feeds the credit cycle and will make it more cyclical and more severe.

On the bright side, the industry today is, I think, relatively well capitalized. So for the longer term prospects, given the fact that I don't think you're going to see the kind of loan demand that we saw over the course of the 1980's into the 1990's, if capital is not extinguished rapidly, and if you do get forbearance by regulators and not a severe recession, we'll probably come through this with capital intact.

There will be a lot of dislocation. There will be banks who are grossly undercapitalized who need capital and many banks will fail while others continue to thrive and prosper. However, as long as no large pools of capital are extinguished, we're not going to have the overflow effect.

Given the oversupply of real estate, you're not going to have the call on those resources that you did in the 1980's. As we said 62 percent of all bank loans made in the last 6 years have been for real estate. If you don't need to build office buildings, you won't have the call on the capital you did over that period.

So it may not all be black. It's going to make it much more difficult for those banks that would have significant problems to earn their way out of this credit cycle like the multinational banks did with their LDC problems. They had the time and the growth in other income to make their way through that credit cycle.

I think what you're going to see is a lack of loan demand. As much as you are going to see credit crunch, you're also going to see a lack of loan demand. You're not going to see it from real estate the way you saw it, particularly on the commercial side. Yes, on the residential side, but probably not on the commercial side.

Further, consumers are laden with debt. They may not have the same credit demands that they had over the 1980's. And commercial industrial loans, outside of HLT's, have been declining for several years already.

The demands on the system may not be as great as they have been. The bad news part of that is that it's not going to be a vibrant recovery either. If you're looking for debt growth to pull you out of recession, it's probably not a reasonable expectation. I don't think corporations will be willing to take on that much more debt, nor are consumers.

So I think that you can make a strong case that we see a very slow recovery. So I think that, if there's anything that I would look for in all of this is that the banks that survive will do so by having already good credit standards, but also by cutting expenses and reducing overhead. And any legislation such as interstate branching, which will help them reduce their costs, I would encourage you to consider.

And I thank you for this opportunity.

[The complete prepared statement of Carole S. Berger follows:]

For Release on Delivery
Expected at 10:00 A.M. EST
February 21, 1991

STATEMENT OF
CAROLE S. BERGER
SENIOR VICE PRESIDENT
C.J. LAWRENCE INC.
BEFORE THE SENATE BANKING COMMITTEE

Mr. Chairman and Members of the Committee,

I am pleased to be here today to discuss my views on the current health and prospects of the banking industry. As an industry analyst for the past 16 years, I can say without reservation that the last couple of years have been the most challenging. Change is being forced upon the financial services industry at a torrid pace. It is, therefore, appropriate that you, as members of the Banking Committee, try to fully understand the problems of this industry before considering legislation to change it.

Currently, the economists at C.J. Lawrence Inc., Edward S. Hyman and Nancy Lazar, are somewhat less optimistic than either the Federal Reserve or the Administration on economic growth this year. They are projecting real GNP growth of -1.5% in 1991, with the greatest weakness in the first half (-3.0%) and a slow recovery in the second half. I concur with this forecast, and therefore, my views, as expressed in this testimony, incorporate such a scenario.

SUMMARY AND CONCLUSION

Without a doubt, we are in the middle of the worst credit cycle of the postwar era. Problem loans (nonperforming asset ratios) are at their highest level of the last 50 years. The largest, most problematic sector today is commercial real estate. We started the last decade with office vacancy rates below 5% but ended the 1980s with roughly 20% of all office space in the U.S. empty. Recession is likely to exacerbate this oversupply problem, fueling the already sharp deterioration in property values and necessitating huge write-offs at commercial banks.

Unfortunately, this is not the only problem the banking industry faces today. Traditionally, with recession come credit losses, both commercial and consumer. Commercial losses rise as corporate profits are pinched by high real interest rates and/or a drop in revenues as the economy slows. Consumer losses are directly related to the level of unemployment. Typically, commercial and consumer credit losses do not crest for almost a year after the trough in the economy. The real estate cycle is much longer. Further, the severity of the credit cycle will be correlated with the harshness of the economic downturn. As bank analysts, our forecasts of credit losses over the next couple of years are only as good as our predictions for the overall economy. The more severe the downturn, the worse the credit losses.

The role of the banking regulators is crucial to the longer-term prospects of the industry. It would be difficult for me to overstate the problems within the real estate markets. As I discuss more fully in my testimony, I think that over the course of this real estate cycle, banks, as an industry, may need to write-off 6% to 7% of their total assets. With capital ratios at or below these levels, if banks were required to write-off these losses quickly it could cause the insolvency of the U.S. banking system. In an industry that returned 0.75% to 1.00% on assets during the 1980s, if such write-offs were recognized over the course of 5 to 10 years, it would absorb most of the industry's earning power but little of its capital.

This is not a minor point. It is the capital impairment that causes the overflow impact into the economy. Banks are highly-levered organizations. If a bank is required to carry 4% equity to assets, every dollar of capital written-off requires that $25 be drained from their balance sheets just to maintain that same 4% equity-to-assets ratio. Therefore, if huge sums of bank capital are extinguished quickly, the overflow impact could be disastrous. If the problem is recorded more slowly and little or no capital is extirpated, then the overflow impact is far less worrisome.

The decade of the 1980s saw an incredible buildup of debt: corporate, individual, and government. This credit cycle is part of the liquidation phase of that debt boom. The riskiest loans will go bad and will be reflected as loan losses on banks' financial statements. The severity of the cycle will tell us how much bank capital will need to be charged-off. This raises the issue: Will the banks be able to fund loan growth at the other end of the cycle? At this juncture, given our (C.J. Lawrence Inc.'s economists Edward S. Hyman and Nancy Lazar) view of an average economic downturn and assuming some regulatory forbearance, we think the U.S. banking system is adequately capitalized (although some of its largest members require massive infusions of new capital). One reason that we are so sanguine about capital levels is that we believe loan growth in the 1990s may never approach the level of the last 10 years. Since 1985, roughly 62% of all loans added to bank balance sheets were real estate loans. Given the oversupply of commercial real estate, I doubt seriously that loan demand will be as robust as it was in the 1980s. Similarly, consumer and corporate debt levels are unusually high, and both sectors are likely to borrow less heavily in the 1990s than they did in the 1980s.

We view this as both a positive and a negative. On the positive side, if loan demand is low, then the banking industry is not as undercapitalized as many fear. It follows that whatever loan demand does develop could be funded within the context of the banks' existing capital bases. From a macroeconomic basis, this lack of loan demand may result in a far less robust economic recovery. On the negative side, if it is truly a debt-liquidation cycle and consumers and corporations do not wish to borrow, then many banks will find it difficult to earn their way out of the credit cycle. In such an environment, expense reductions achieved by internal means or from synergies created by consolidations within the industry may be the key to the future viability of the banking industry.

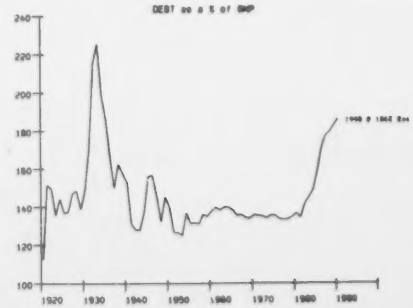
If the economy is much weaker than our forecast of an average recession, credit losses in each asset class -- real estate, commercial, and consumer -- would be aggravated. If regulators maintain the stringency of the regulatory oversight that they exhibited in 1989 and 1990, we fear a much more severe economic impact due to rapid write-offs of bank capital. This was the case in New England, a region that is likely to be much weaker than the rest of the country for much longer. We are not suggesting that regulators allow capital ratios to fall. However, we would caution them not to raise capital requirements during this period of stress. Further, we need new accounting treatment that stretches out the timing of the recognition of real estate losses so as not to impinge on the capital base of the industry.

This credit cycle is not totally without precedent. We believe it will end as credit cycles normally do, through aggressive Fed easing. This would reliquefy the capital markets, bringing interest rates to a level that encourages capital spending and consumption. As an industry analyst for the last 16 years, however, I believe there are as many differences in this cycle as there are similarities. I believe we are at a turning point for the industry and perhaps the economy. Given the already high levels of debt in the U.S. economy, it is unlikely that debt will be the major vehicle to foster economic growth or a recovery in bank earnings. I would urge you, as members of the Senate Banking Committee, to consider legislation that encourages expense reduction and/or consolidations within the banking industry to foster a more efficient system. One such idea is the Treasury proposal for interstate branching. The cost savings for operators of large multistate franchises could be enormous. Further, I would urge you to reform the deposit insurance system; specifically, I believe the too-big-to fail doctrine must be phased out.

Credit Cycle

The debt boom of the 1980s brought debt in the U.S. economy to the highest level relative to the size of our gross national product (GNP) since the 1930s. Figure 1 shows the history of debt as a percentage of GNP from the 1920s to the present.

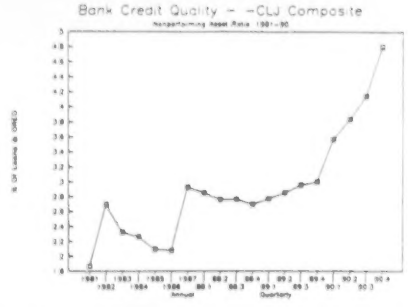
Figure 1



It is the back side of that debt balloon which is creating the worst credit cycle in the postwar period. Credit quality at U.S. commercial banks deteriorated sharply last year. For the 45 banks that we follow closely, nonperforming assets ratios grew from 3.0% at year-end 1989 to 4.8% at year-end

1990. Nonperformers today are almost double the level reached during the 1981-1982 recession. Figure 2 shows nonperforming assets ratios for these 45 banks since 1981.

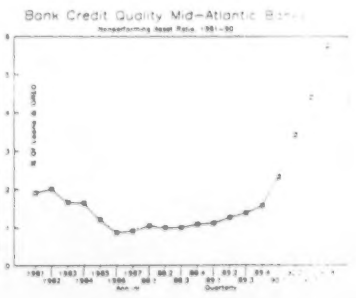
Figure 2



There are significant geographic differences in the level of problem assets today. However, trends do not differ materially. New England banks and banks in the Middle Atlantic states have fared far worse over the the last 12 months because of an overexposure to real estate and weakening local economies with nonperforming asset ratios of 9.3% and 5.8%, respectively. Nonperforming assets ratios for these areas are shown in Figures 3 and 3A.

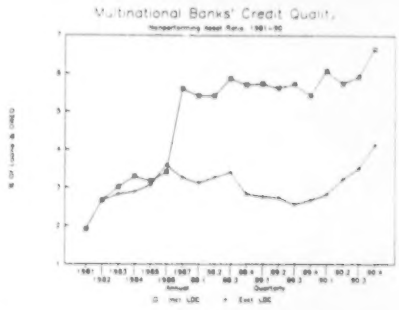
Figure 3

Figure 3A



Even for the multinational banks, nonperforming assets ratios grew from 5.4% at year-end 1989 to 6.7% by December 1990. Figure 4 shows multinational banks' credit-quality ratios. As you can see, when we exclude LDC nonperformers, credit-quality trends of their non-LDC portfolios look even worse, rising from 2.7% at year-end 1989 to 4.1% last December. Over the last few years, charge-offs of LDC credits have held total nonperforming asset ratios incheck, even as non-LDC credit quality deteriorated.

Figure 4



Real Estate

Real estate is by far the largest problem in the banking industry today. Figure 5 shows commercial real estate mortgage loans as a percentage of total loans. Today they are 17.7% of the total loans of U.S. banks. In addition, real estate construction loans account for another 7% of bank lending.

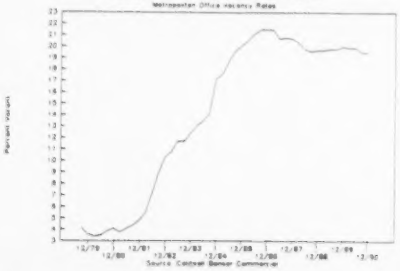
Figure 5

There has never been an asset class as large as commercial real estate loans that has had problems. When LDCs were a problem, they were a huge problem for the dozen largest banks, where exposures averaged under 12% of total loans. For the banking industry as a whole, however, LDC debt never exceeded 5% of total loans. Similar statements could be made regarding agricultural and energy loans.

Over the course of the 1980s, the banks lent aggressively on real estate, doubling their relative exposure. Since 1985, 62% of all incremental bank lending was on commercial real estate. Office vacancy rates (shown in Figure 6) also rose rapidly over the course of the 1980s.

Figure 6

National Average, 1979–1990



During the early 1980s, office employment growth kept pace with building. Real estate space was absorbed at roughly the same pace as it was being created. Rents remained stable and even rose in some markets. The environment changed rapidly as the rate of office employment growth began to drop in the late 1980s. Figure 7 shows office construction contracts versus office employment growth. As construction contracts have slowed dramatically, so too has the rate of creation of new office jobs.

Figure 7

Office Construction Contracts vs
Office Employment Growth

As local economic activity slows, real estate developers with a huge oversupply of office space begin cutting rents. The more serious the downturn in the economy, the less real estate space is absorbed and the further real estate developers drop their rents. As rent rolls decline, so does the value of that real estate. A piece of commercial real estate is valued by the net present value of the cash flows that can be expected from it over time. In some markets, such as New York and Boston, effective rents have already declined 50%. Every time a real estate developer has to renegotiate a lease as it comes up for renewal, his cash flow is being impaired. His tenant will either insist on dramatically lower rent or move out. Either way, the developer has a cash crunch, making it difficult to pay maintenance costs and mortgage interest. Further, he would find it difficult or impossible to sell the property, since those reduced cash flows are the determinant of what someone would pay for that building. Put more simply, declining rents reduce property values.

In broad terms, this can be an immense problem for the U.S. banks. As we already noted, real estate loans are at roughly 25% of total bank loans, which is equivalent to roughly 20% of total assets. If cash flows on a national basis decline as much as they have in Boston and New York, property values may decline nationally by more than 50%. If we assume that banks lent 75% of the original appraised value of the property, it is possible that over the course of this cycle banks will need to charge-off $25 out of every $75 they have lent, or 33% of their real estate loans. This is equivalent to 6%-7% of their total assets. In turn, this is roughly equivalent to the equity and the reserves in the system today. Therefore, if these charge-offs were required quickly, it could cause the insolvency of the banking industry.

The U.S. banking system over the course of the 1980s was capable of producing returns of 0.75% and 1.00% on assets. It follows therefore, that if banks were allowed to report these losses over a 5- to 10-year period, such charge-offs may absorb all of their profits but none of their capital. This is a very important distinction.

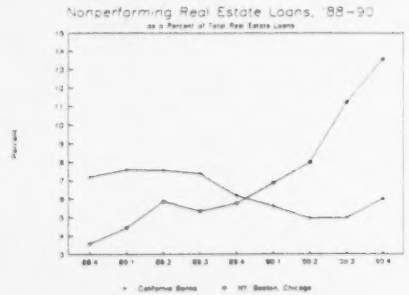
When you cause a bank to charge-off capital and then instruct it not to allow its equity-to-assets ratio to decline, that bank must reduce assets. A bank with a 4% equity-to-assets ratio would need to reduce assets by $25 for every $1 of capital charged-off. This is not a credit crunch; I call this a credit implosion. Huge charge-offs over a short period of time could have disastrous effect on the economy.

There are two issues that immediately come to mind. First, where will the property values stabilize? The problem was created by a combination of oversupply and slowing office employment growth. Demographics argue strenuously against a quick resolution of this problem. Further, the impact of recession on employment could exaggerate the oversupply problem. This could panic real estate developers into dropping rents further, causing property values to fall and bank losses to escalate. In Texas, the cycle was not broken until rents fell to a level barely sufficient to cover operating costs. In Texas, at the trough of the cycle, the net present value of the cash flows of downtown office properties was close to zero. This caused most of the major banks in the state to seek out-of-state mergers or Federal Deposit Insurance Corporation (FDIC) assistance. I fear the same type of environment might come to pass in New England over the next couple of years.

The second issue: How will bank regulators react to falling real estate values? Aggressive action by bank regulators in late 1989 and early 1990 in New England caused the rapid charge-off of almost $2 billion of bank capital at the six largest New England banks. The credit implosion which was created pushed that economy into what I believe will be a severe economic downturn. Regulators need to walk a tightrope. They must be stringent enough to protect depositors, yet forbear enough not to create credit implosions in other major marketplaces.

Deterioration in real estate accelerates dramatically as the economy slows. Figure 8 shows nonperforming real estate loans for the eight largest banks of New York, Boston, Chicago, and our index of four California banks. For eastern banks, nonperforming real estate loans are approaching 14% of total real estate loans. For California banks, nonperforming real estate loans are still under 6% of real estate exposure. We believe this is because the eastern economy deteriorated much earlier.

Figure 8



Unfortunately, real estate is not the industry's only problem. With recession come credit losses in the consumer and commercial portfolios as well.

Commercial Credit Cycle

Figure 9 shows nonperforming loans, excluding real estate and LDCs, for our New York, Chicago, and Boston banks. The deterioration of these commercial credits over the last year has been rapid and very meaningful. On the West Coast, where the economy is more vibrant, credit quality has deteriorated, but not nearly to the degree that it has at the other banks. The cause of the commercial credit losses can be linked to the effects of high real interest rates and/or slowing demand on the revenues and expenses of corporate America. As corporate profits decline (see Figure 10), debt-laden corporations have trouble meeting interest and principal payments.

Figure 9

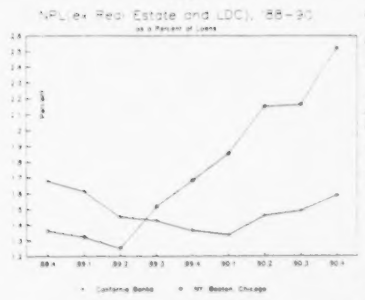
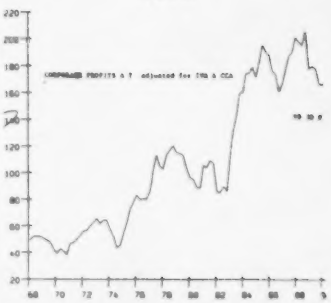
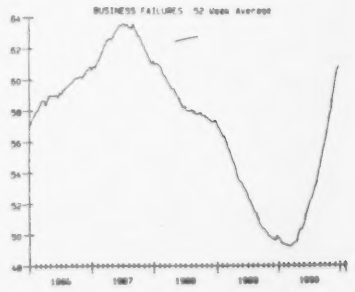


Figure 10



These are the causes for business failures. Figure 11 shows a 52-week average of the number of business failures. Last year showed an amazing increase in the number of failures, and we would not expect this trend to crest until sometime after the trough in the economy, most likely early 1992. Business failures are a lagging indicator of the economy. We therefore cannot expect commercial loan problems to peak until early to mid-1992. Clearly, the weaker the economy, the more business failures and the higher commercial loans losses.

Figure 11



Consumer Credit Cycle

Consumers are also heavily laden with debt. Figure 12 shows consumer debt as a percentage of personal income.

Figure 12

As unemployment rates rise, consumers' ability to make the interest payments on time, if at all, is diminished. The severity of the consumer credit losses will depend on the level and timing of the peak in unemployment rates. C.J. Lawrence economists now anticipate unemployment rates, which are also a lagging indicator, to peak in late 1991, at roughly 8%. Figure 13 shows unemployment rates on a national basis. They have <u>just recently</u> started to rise dramatically. We expect consumer losses to reach their zenith late this year or early in 1992.

Figure 13

In summary, this credit cycle is far from over, even if we are now witnessing the weakest point in the economy. Real estate problems may endure through the mid-1990s, and commercial and consumer credit problems are unlikely to be on the mend until mid-1992. It is evident from my remarks that the less sanguine one is about economic prospects, the more concerned one has to be about the health of the U.S. banking industry.

Longer-Term Outlook

If a serious recession can be avoided and regulators can successfully walk that tightrope, it is likely the credit cycle will run its course without bringing about the demise of the U.S. banking system. Recent Fed actions to add liquidity to the system by cutting reserve requirements, lowering the discount rate, and pumping reserves into the system should begin the process of recovery. C.J. Lawrence economists Edward S. Hyman and Nancy Lazar are now forecasting real GNP to decline 1.5% this year, with the weakest performance in the first half, followed by stabilization and slow recovery in the second half. Under such a scenario, commercial and consumer losses and problem credits would accelerate over the very near term, with problem credits peaking by mid-1992. In already weak markets, real estate will deteriorate rapidly as "rent wars" spread and property values plummet. It is also likely that similar problems will arise in markets which have not yet deteriorated significantly. Under such a scenario, bank earnings would likely trough in 1991. One must expect, therefore, that 1991 earnings for this industry will be worse than they were in 1990. An earnings rebound may occur as early as 1992. However, we caution that it may not be vibrant.

Even so, as long as the industry continues to make money, no large pools of capital will be extinguished. Today, the industry is relatively well capitalized. Therefore, as long as large pools of capital remain intact, credit implosion on a grand scale can be avoided.

There will be major dislocations. . Weak banks that lose large portions of their equity capital will fail. There are also likely to be major geographical differences. In New England, for example, the economy will be much weaker and slower to recover than the national average. The banks in that region, therefore, have much greater problems. In fact, we believe a Texas-style downturn could result in a similar banking environment, necessitating out-of-region mergers and/or FDIC-assisted transactions for a fair number of those banks.

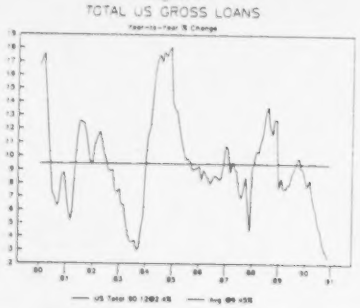
The real estate cycle, by its very nature, will be much harder to resolve. Cash flows in commercial real estate will continue to decline even as the economy recovers, making the earnings recovery of the banking industry somewhat slower than in past cycles. However, if this real estate cycle is not coincident with severe commercial and consumer credit cycles, and assuming regulators do not force rapid write-offs of real estate assets, total capital in the system is unlikely to decline significantly.

<u>We continue to stress capital</u>. It is capital and the leverage of that capital which allow banks to fund their loans and investments. Much has been written about a credit crunch. Our view is that there is still enough capital to make loans. It is a normal human reaction, into the face of a slowing economy, to view the world as a riskier place. Therefore, bankers who are not tightening their credit standards are in the minority. As the recovery unfolds, bankers will again begin lending and borrowers, at the lower interest rates that Fed easing brings, will begin borrowing.

We believe that this is where the similarities to past cycles may end. Debt in the U.S. economic system is close to an all-time high, and it is likely that the economy will go through the debt-liquidation phase. As we discussed, the credit cycle is part of that phase. The second part will be much lower loan demand than existed in 1980s.

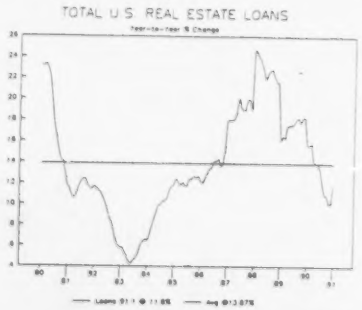
Figure 14 shows year-to-year growth of total loans over the decade of the 1980s. Growth was very variable, averaging 9.45% over the past dozen years.

Figure 14



Real estate loans (shown in Figure 15) grew even faster, at an average of 13.9% in the last 12 years.

Figure 15



Given the oversupply of commercial real estate in the U.S. (which some have estimated over at 10 years), we doubt seriously that loan growth in this area will even come close to what it was over the last 10 years.

Figure 16 shows the growth in construction spending since the mid-1970s. Spending exploded after the 1981-1982 recession for both commercial and residential. Today, 44% of construction spending is for non-residential purposes (see Figure 16A). This is roughly the same proportion it has averaged over the last 14 years. As construction of current office buildings are completed, we believe spending in this sector will fall well into the mid-1990s. Therefore, construction lending will likely continue to decelerate.

Figure 16

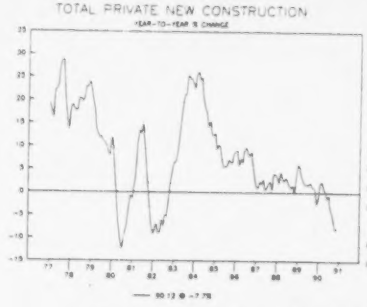


Figure 16A

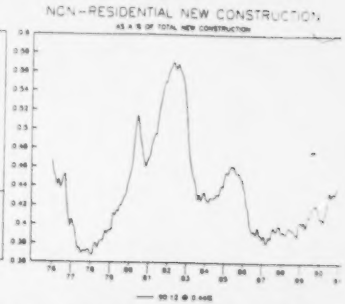
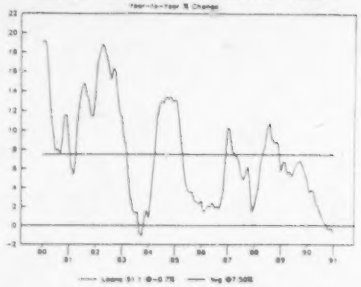


Figure 17 shows commercial and industrial loan growth over the decade. This area grew at an average of 7.5% during the last dozen years. Since 1986, the pace has slowed considerably. A goodly portion of the loan growth in this area was for highly leveraged transactions (HLTs). Many of the corporations that employed leverage are now finding it difficult to service their debt, and the returns of the equity investors are nowhere near what was originally projected. This type of lending will not be as attractive to investors in the 1990s as it was in the 1980s. Therefore, we believe that commercial and industrial loan growth may not be as robust as it has been.

Figure 17

TOTAL U.S. COMM'L AND INDUSTRIAL LOANS



Similar arguments can be made for the consumer. Even after the recovery, consumers, with debt now 79% of their personal income, may be very reluctant to borrow.

Our forecast is for very modest loan growth, even after the recovery is in place. Therefore, with capital at an adequate level today, and barring the kind of environment that would create huge losses for the system, we would expect banks to have enough capital to fund whatever loan growth exists.

The negative side of this forecast suggests the economic recovery may be less robust than in past cycles because it will not be fueled by increasing leverage within the financial system. This, in turn, may drag out the credit cycle itself. Furthermore, some banks will find it much more difficult to grow their way out of their credit problems. That is what multinational banks did in the mid-1980s. During the period of time (1984-1987) that multinational banks were recognizing that the payment problems of Latin American countries were not just short-term liquidity problems, loan growth averaged a little over 10%. This allowed large banks to generate income to build reserves and capital, which they have used over the last few year to absorb losses from LDC credits.

The environment of the 1990s is unlikely to be as hospitable. The keys to profitability over the course of the 1990s are more likely to be expense control and intramarket mergers that might provide significant cost savings. We would favor any legislation that would encourage bankers to seek partners where true synergies exist. Further, of all the Treasury's banking proposals, we find interstate branching particularly appealing for large multistate organizations. Forced by arcane banking laws, banks are required to operate as separate entities in each of the states in which they currently do business. Interstate branching would lower costs and could be a major positive for the health of the industry as a whole.

The CHAIRMAN. Well, very good. There are several questions that come to mind. And I think as we go along, if there's any particularly compelling issue that anybody wants to interrupt to raise, we probably ought to do it while it's right there and then we will move along, because I think we can be a little more informal today.

Senator D'Amato, I know you have a statement. Do you want to put that in the record?

Senator D'AMATO. Yes. Mr. Chairman, in the interest of time, I would like to submit this statement for the record as if it is read in its entirety.

STATEMENT OF SENATOR D'AMATO

Mr. Chairman, thank you for convening this hearing today to discuss the condition of the banking industry and the economy.

At yesterday's Banking Committee hearing, we were able to hear from the Chairman Greenspan of the Federal Reserve, the guru of monetary policy. Chairman Greenspan assured us all that the Fed has been moving against the credit crunch by implementing expansionary monetary policy to increase the money supply. When the chairman of this committee asked Mr. Greenspan if we weren't already too far behind the credit crunch to be able to do anything about it, Mr. Greenspan responded that they were aware of the problem.

Of course they are aware of the problem—it has become their gremlin. Every American is aware of the problem—eventually even the Federal Reserve cannot deny the existence of the problem. Interest rates have been creeping downward, quarter point by quarter point—more likely the result of decreased demand for loans and not the result of concerted action by the Fed to lower interest rates.

Once again, the Fed has done too little too late. We are about to perform a complicated operation on the industry, but we need to keep the patient alive in the meantime. Once the economy falters to such a degree that the banking industry is in danger of being the savings and loan disaster of the 1990's, there will be no patient to operate on. Even extraordinary efforts on the part of Congress will not be enough to resuscitate this patient.

I am concerned that the Fed's failure to act sooner will have irreversible effects, particularly with respect to the real estate market which continues to deteriorate. Interest rates should be even lower than they are now. The Fed should lower the discount rate down to 5.5 percent, and then 5 percent if they have to. The discount rate was 5.5 percent for an entire year beginning in mid 1986, before the Fed began its myopic program of contractionary monetary policy. Certainly the economy is in worse condition now than it was in 1986, and certainly the economy would benefit from the stimulus of lower interest rates. Even Chairman Greenspan has conceded that the economy has not yet bottomed out.

I would be interested in hearing from today's witnesses about their opinion of the effect lowering interest rates sooner would have had on lessening the impact of the recession on consumers and the banking industry and whether lower interest rates could have offset the economic downturn.

And I wonder, Mr. Chairman, I would take the liberty that you have mentioned. If we could get the panelists to comment, I have made my feelings known, very upset about the manner in which the Fed has failed to respond to the recession. I think they are late in recognizing it. And so while they have reduced interest rates, it seems to me that those interest rate reductions have taken place a lot later than sooner.

The impact is that when you have a guy who closed his business, let's say he's one that relies on interest payments as a heavy part of his payment, I'm thinking about the retailers, and the auto business. Well, now the prime rate is down let's say a point, a point-and-a-half. It doesn't help him once he has closed his doors. That's been my point.

Yeah, they have reacted, but once you've got guys closing the doors, you can't save that business. There may be others, but I think we've seen a lot of people who have been sacrificed because of the slowness in the response of the Fed, and I don't understand why its discount rate is at what it is today, 6 percent when in 1986 and 1987 the August period of that time, between 1986 and 1987, it was 5.5 percent.

I'm wondering if our experts here would comment. Now I know that maybe you don't want to take the Fed Chairman on, you know, so you don't have to. But do you think we've really been responding adequately, the Fed, as it relates to its interest rates policy?

The CHAIRMAN. Let me suggest that as you go along, if you've got a thought on that that you want to relate, that you do that in response to Senator D'Amato.

Did you have anything you would like to say on it, Ms. Berger, before I go to Senator Graham, who I think has a question for you?

Ms. BERGER. I am not an economist. I am a bank analyst. I preface my remarks so you know I am speaking out of school.

I think that the Fed, over the course of the last year, has really been following rates down.

It appears to me that what we have seen is partly credit crunch, but on the other side of it we have also seen a lack of credit demand and that lack of credit demand has brought down interest rates.

And up until the second discount rate cut, I really thought that the Fed was following rates down and it was not until the second discount rate that I thought the Fed was actively starting to ease. Up until that point they had not added a lot of bank reserves into the system. And if banks don't have reserves, new reserves, you are not adding to the liquidity in the marketplace.

The CHAIRMAN. Senator Graham, did you have something that you wanted to raise there?

Senator GRAHAM. Yes, Mr. Chairman.

First, I would like to say how much I appreciate the fact that you and Senator Garn are scheduling this series of hearings and particularly this one today, which attempts to look at some of the broader economic circumstances that set the context for the specific decisions that we're going to have to make.

I believe that this issue of financial institution reform offers a tremendous challenge and opportunity to this committee to exer-

cise its responsibility at appropriate diagnosis of the problem and, after that diagnosis, prescription. I think there has been, maybe, in the past some tendency to prescribe before we fully understood fully just what the pathology was and we've paid a heavy price when we have fallen into that trap.

I have some other comments to make, but I would like to ask Ms. Berger some further questions relative to the real estate analysis that she has just given.

In terms of the loan increase that you commented on, as between three types of banks, money center banks, regional banks, and community banks, was there a difference in the pattern of increase of real estate loans over the period that you're analysis covers?

Ms. BERGER. Not in a pattern. In the relative exposure, yes. Large multinational banks as a class tend to be somewhat less exposed than regional banks and community banks.

Senator GRAHAM. Let me ask the question maybe more precisely. Was the percentage increase in real estate loans different as among those three types of banks? Did money center banks increase their proportion of real estate lending more or less than community banks or regional banks?

Ms. BERGER. There was no significant difference.

Senator GRAHAM. The second question is, was there a difference in the rate of real estate lending before and after the 1986 Tax Act?

Ms. BERGER. There was a late surge in real estate lending. The banks had started lending on real estate earlier in the decade and there was a surge after the Tax Reform Act was passed.

Senator GRAHAM. Bank lending increased after the 1986 Tax Act?

Ms. BERGER. There was one last surge because there was a window where developers could, if they broke ground they could still get the tax credit, so there was one last surge of bank lending.

Senator GRAHAM. But after the full consequence of the 1986 Tax Act went into effect, what was the pattern of bank lending for real estate loans?

Ms. BERGER. If you have a copy of my testimony in front of you, there is a chart on page 13 which shows that real estate loans on a year-to-year basis actually didn't crest until 1988.

Senator GRAHAM. That is page 13?

Ms. BERGER. Page 13, figure 15.

So in answer to your question, no, not really. It has been decelerating since 1988. But most of these were loans that were committed to before the tax law was passed and funded in late 1987 and 1988. So the rate of growth crested in late 1988 at about 24 percent.

Senator GRAHAM. In testimony earlier this week, when I asked Mr. Greenspan what was his analysis of what had happened to credit and he put a great deal of emphasis on the 1981 Tax Act, which had created value in real estate, and then the 1986 act which had withdrawn a significant amount of that value. Your chart as well as some anecdotal information that I have received indicates that lending activity did not take that withdraw of value of the 1986 Tax Act into significant account, at least in the period immediately after the Tax Act was passed.

Ms. BERGER. You have to remember that real estate lending because of the building cycle is very long lending.

When a bank lends, he is making a forward commitment and the loans don't actually show up on his books until the guy is in the building process.

So you get a buildup of loans that crest well after the loan commitment. It can be 2 or 3 years after the commitment is made. So I'm not sure that you can draw from this evidence anything that really terribly disputes Mr. Greenspan's statement.

Senator GRAHAM. So you are saying that the decisions may have been prior to 1986, but the statistical numbers that show up on your chart 15 were the playout of those earlier judgments; is that correct?

Ms. BERGER. Correct.

Senator GRAHAM. Thank you.

The CHAIRMAN. Thank you.

Mr. Weiant, we would be pleased to hear from you now.

STATEMENT OF WILLIAM WEIANT, MANAGING DIRECTOR OF THE FIRST BOSTON CORPORATION, BOSTON, MA.

Mr. WEIANT. Mr. Chairman, Members of the committee, I appreciate the opportunity to appear today to discuss the condition of the banking industry.

My name is William Weiant. I am the managing director of the First Boston Corp., and am responsible for research on bank stocks in our Equity Research Department.

A large portion of my time now is spent with investors and, therefore, we give the perspective not only of the equity analyst but also of the investment community.

Maintaining public confidence in the banking system is integral in terms of reviving and managing and maintaining stable economic growth. As we all know, the economy requires a banking system that has the confidence of all participants.

The banking system, though, cannot be replaced by other financial or quasi-financial institutions. While competition for specific bank products will continue to increase, many of these products such as commercial paper depend on the banking system for its safety net and cannot exist without that safety net.

The current state of the financial system and the banking system has to be seen in the broad context of the last 20 years. In the 1980's the United States entered a period of disinflation, which is characterized by slower rates of increase in inflation accompanied by secular declines in interest rates. Deflation, which is the actual decline in prices rather than just disinflation, has been evident in broad sectors of the economy in recent years.

Now many of today's banking ills can be traced to deflation in real estate values, as reflected by significant declines in real estate prices. The real estate problem has been aggravated by the Tax Reform Act of 1986, more importantly by the demise of the thrift industry, which is often overlooked by many, as well as some changes in terms of lending by banks and other financial institutions.

Nonetheless, in our view, the banking system is essentially sound. And, in my own personal view, credit is available to creditworthy customers. While some structural changes are desirable in banking, Congress and the administration should be careful not to undermine the investor confidence by applying bandaids or adopting unique accounting wrinkles in an attempt to revive economic growth.

As we found in the savings and loan industry, such techniques simply aggravate the basic underlying problem for the future.

I'll focus on some of the negatives of the current banking system, but let me also note some of the positive forces which are at work. Everything is not a dark cloud in the banking industry today.

The positives include the following. Despite the fact that there are large provisions for loan losses in the industry, banks in 1990 reported $28 billion in earnings and we believe a similar level of earnings is likely in 1991, with an improvement in 1992 and 1993.

Profitability in banking is measured by the return on assets and the returns on equity. For the 45 banks that we monitor, these are still relatively healthy profit levels.

The return on assets, for example, is expected to be 0.70 percent in 1991 and the return on equity surprisingly high at 12 percent.

The CHAIRMAN. Could I stop you for a minute.

When you say you follow 45 banks, you have constructed a composite. Are those ones that—can you tell us a little bit about the profile and are those ones that——

Mr. WEIANT. The profile is actually included in table 2 of our written testimony. It includes a broad range of banks, including money centers, regionals, large super-regionals, and a few, I guess we would call them regional banks. Basically the banks would be, I would say, minimum size would be $5 billion in assets.

The CHAIRMAN. But your composite is designed to try to give you——

Mr. WEIANT. A good view of the overall industry, correct.

The CHAIRMAN. OK.

Mr. WEIANT. That is correct.

Similarly, in terms of capital, tangible common equity, and we think that is the only way to measure capital adequacy, of these 45 banks is estimated to be in excess of 5 percent at year end 1991, which is well above the regulatory minimums.

Let me quickly highlight though some of the areas of concern. I hate to say it. I think there are seven of them.

No. 1, let's look at real estate. We think the nonperforming real estate loans are going to increase in1991. We anticipate for the average bank nonperforming real estate would increase approximately 50 to 75 percent. In some cases it could double.

Given the fact that we have a rolling recession, we think that real estate problems will become evident in both the midwest and in California during the year.

No. 2, highly leveraged transactions, HLT's. Approximately 15 percent of HLT's are expected to go on a nonperforming status for the average bank. That would be about three times the level of September 30. Ultimately, we expect 20 to 30 percent of nonperforming HLT's to be charged off, which would result in approximately a 3 to 4½ percent chargeoff rate on HLT's.

No. 3, reduced access to the capital markets. A major problem in 1990 was the fact that banks were almost excluded from the capital markets, reflecting downgradings of banks by the rating agencies. In recent months, there has been some improvement in the access to capital markets for banks, although this remains primarily limited to the strongest banking companies. And even there, the costs of borrowing are historically high.

No. 4, equity capital. Equity capital is not a problem for the banking industry. Equity capital is a problem for a specific number of banks. Unfortunately, these banks include many of the Nation's larger banks, where capital was initially impaired by loans to LDC's and, more recently, by nonperforming real estate loans and also HLT problems.

No. 5, the FDIC. The reports of various outside experts and Government agencies are not particularly convincing to us as to the extent of embedded losses facing the deposit insurance fund. At the moment, we think the likely source of the large level of funds needed to deal with this crisis is in the banks themselves and can be provided by the banks themselves.

A fundamental problem, however, for the FDIC in the system is that there is overcapacity and various capitalization or recapitalization schemes for troubled banks, which are being described in the press, would appear to prevent this problem of overcapacity from correcting itself.

In other words, bankrupt banks should be allowed to disappear from the system in order to preserve—to make the remaining competitors stronger.

No. 6, credit availability. I think too much emphasis is placed on the fact that bank credit is not available. In my own view, I think there is plenty of liquidity in the system and that, for good borrowers, loans are available. Banks are simply taking a more prudent approach to lending. Given the slowdown in the economy, it should be something that should be welcomed given the burden of debt that is evident in all sectors of the economy.

Finally, No. 7, the role of regulators. There is no doubt that some of the examination reports in 1989 and 1990 came as a shock to bank managements. In our view, the examinations though were simply recognizing erosion in real estate values that had been occurring for at least 2 years and simply had not been properly identified by bank managements. The regulators were doing a service to the industry, not a disservice.

In conclusion, let me make a few comments that relate to what we think should be done for the system going forward.

What we are trying to do is to find a way to bring more investment and more capital into the system.

There is a necessity to maintain strong equity capital ratios.

There can be no relaxation in the capital requirements set forth by the BIS, and more recently in FIRREA.

Second, to maintain competence, bank regulators have to maintain a strong, regulatory process.

This means a heavy focus on examination.

It means early intervention.

It does mean removal of managements.

And they should also remind boards of directors of their fiduciary responsibility.

As to various structural changes being contemplated, we have the following observations.

No. 1. Barriers to nationwide interstate banking, such as the Douglas Amendment, should be removed quickly.

No. 2. Proposed changes in bank powers, such as security powers, will have little impact on bank profitability overall, and will not be a panacea to the supposed earnings problems of large banks.

No. 3. Permitting industrial companies to invest in banks will only bring marginal amounts of capital into the industry.

No. 4. The Too Big To Fail Doctrine should be the responsibility of the Treasury and of the Federal Reserve. It should not be the responsibility of the FDIC.

If Congress makes a policy decision that preserving select banks is in the national interest, then the Treasury and Federal Reserve should pay for it.

No. 5. Regulations initiatives, policy directives, and so forth should be directed at the problems of all banks.

All too often, from my view, these policy initiatives seem directed at the ills of the New York banks.

No. 6. The insurance of accounts should not be tinkered with at present because of the possible adverse effect on depositor confidence.

Finally, I think there is going to be a major change in the composition of the banking industry over the next few years, and I hope that you will allow it to happen.

Essentially, we will have new, nationwide entities that will be primarily anchored by what we call mega-regional banks.

They will become the dominant forces in U.S. banking in the decade of the 1990's.

And these are banks that are strong in capital, core-funded, and largely responsible for local needs, rather than trying to engage in international activity.

I thank you for inviting me, and I will be happy to answer any questions.

The CHAIRMAN. Let me just pose one question before we go on. And if my colleagues have something that's topical right at this moment, we'll do that, too. But we'll come back for a formal question period.

I want to ask you to reflect, just for a minute, on the savings and loan experience in one dimension.

And that is that over the years of the 1980's, while there was a general knowledge that there were problems out there in the industry, I think it's fair to say that the scope and the scale of the impending disaster was never fully realized even within the industry itself.

And if you go back and do a reconstruction, you'll find that of all the losses that we've taken over the last 2 or 3 years in the savings and loan system, 70 percent have come from State-chartered institutions in just two States: Texas and California.

Now, if you want to, you could say, just hypothetically, if you didn't have that problem, if that problem hadn't come along and really blown a hole in the side of the system, if in those States,

State-chartered institutions had been essentially on a par with an average of the rest of the country, you would have had a problem of an entirely different dimension—still difficult but obviously radically different.

And I am still struck by the fact that even people in the industry who are chugging along, running large, medium, and small sized S&L's, paying their insurance premiums and so forth, did not, themselves, foresee what was coming down the track from a rather narrowly based problem that was of a genuine catastrophe size. And so then when the whole industry got up-ended, there was a lot of surprise, including to people in the industry.

The people in the industry that behaved well and conducted themselves properly are now, of course, tarred with that brush. And they're saying, why are we having to pay for the sins of others that are unrelated to our own activities.

Of course, that's the nature of harsh equities and how they fall in a situation of this kind.

The reason I take the time to say that is that I am wondering whether it may well be that while you have broad averages in the banking system that look reasonably good from an analytical point of view, can you have a situation where if a part of the situation really blows apart or capsizes, that all of a sudden your averages are misleading to you, and that you can have a systemic breakdown from a fairly narrowly based problem that might catch a lot of people by surprise, even people in the banking system, even bankers in some other place, sort of doing their thing and sort of waking up one day and finding that they're being tumbled in a condition really not of their making, but which is nevertheless taking them along with it. Is there anything like that embedded in the current condition?

I mean, Ms. Berger talks about some things that she sees out there that give her a little more apprehension than I'm hearing from you. But what I'm wondering is, are there, in this broad picture, vulnerabilities in areas that could cause enormous consequences for the entire system, even though they are relatively narrowly based problems?

Mr. WEIANT. Well, as analysts, we were surprised by a lot of things too in the 1980's.

I think the biggest problem, as Carole pointed out, is the real estate problem.

The real estate problem used to be thought of as a regional real estate problem.

It was a Texas problem, it was a southwest problem, and then it was a New England problem.

And what we found is that, unfortunately, real estate problems are essentially rolling through the entire country.

It's this underlying basic economic force that I was talking about that's causing it to happen.

It will happen to different degrees in different regions.

For example, we wouldn't think it would be as severe in the midwest as it's been in New England.

But that is the major danger, as I see it, that we overlook what has happened in other regions and say, well, it can't happen here.

A lot of bankers did that in 1990.

We called it the denial factor.

And most of the banks today are over the denial factor.

I think bankers, today, though, are seeing what you're saying and they are trying to get ahead and address the problem.

It could be that the underlying economic problem is so severe that everyone will be affected.

We're not sure of that.

I think, again, given what the Federal Reserve has done, which is the correct response, which is to ease—who knows whether they've eased soon enough or to the right amount—and also the steps being taken to revive confidence in the system, which was a major problem at the end of 1990, are all good steps in terms of arresting what could be a serious decline, which I think is what you're talking about.

The CHAIRMAN. Well, I want you to think a little more about the question of whether or not there might be something out there that can take an otherwise reasonably squared away situation and tilt it enough off balance that you get a systemic problem.

Do my colleagues want to raise anything at this point, or should we move along to Mr. Grant?

[No response.]

The CHAIRMAN. Mr. Grant?

[The complete prepared statement of William Weiant follows:]

SUMMARY OF TESTIMONY OF WILLIAM W. WEIANT
MANAGING DIRECTOR
THE FIRST BOSTON CORPORATION
BEFORE THE SENATE BANKING COMMITTEE
THURSDAY, FEBRUARY 21, 1991, 10:00 A.M.

The economy, the financial system generally, and the banking system are experiencing significant pressures. Maintaining public confidence in the banking system is an integral ingredient of reviving and maintaining stable economic growth. The banking system is essentially sound, and credit is available to creditworthy customers. While some structural changes are desirable in banking, Congress and the Administration should be careful not to undermine investor confidence as they consider changes in structure and regulation in an attempt to revive economic growth. Such techniques can simply aggravate the problems for the future.

FACTORS LEADING TO CURRENT PROBLEM

The current state of the financial system must be seen in the broad context of the last 20 years. In the 1980s, after rapid inflation through most of the 1970s, the United States entered a period of disinflation which is characterized by slower rates of increase in inflation accompanied by a secular decline in interest rates. Deflation, which is the actual decline in prices, rather than just disinflation has been evident in various sectors of the economy in recent years. Many of today's economic ills can be traced to deflation in real estate as reflected by significant declines in real estate prices. The real estate problem has been aggravated by the Tax Reform Act of 1986, the demise of the thrift industry and changes in terms of lending by banks and other financial entities.

CONDITION OF BANKING INDUSTRY TODAY

Positive Elements The system is basically sound and many positive forces are at work which will significantly improve the profitability of well capitalized, high quality banks, especially those that serve middle market corporate customers and consumers:

> Despite large provisions for loan losses the industry still reported about $28 billion in earnings in 1990 and a similar level is likely in 1991.
>
> The average returns on assets and equity for the 45 banks that we monitor are estimated to be about 0.70% and 12%, respectively, in 1991 -- still relatively healthy profit levels.
>
> The tangible common equity ratios of these 45 banks are estimated to be in excess of 5% at year-end 1991, which is above the regulatory minimums.

Nonetheless, all banks are feeling some effect of the recession and general problems in the financial system. Banks that have 5% or less of their loans in construction and minimum exposure to highly leveraged transactions are posting satisfactory results in almost

all sectors of the United States. Geographically, banks in the Midwest are still showing the strongest earnings results.

Real Estate Non-performing real estate loans are expected to increase in 1991 for banks generally, and given the rolling recession, problems will become more evident in both the Midwest and California during the year.

High Leveraged Transactions (HLTs) Approximately 15% of HLTs are expected to become nonperforming for the average bank and approximately 20-30% of nonperforming HLTs will ultimately be charged off.

Reduced Access to the Capital Markets Bank difficulties in the capital markets reflected downgradings of banks by the rating agencies. Further downgrades in 1991 are expected. In recent months, the capital markets for banks have improved somewhat, although they remain accessible primarily to the strongest banking companies and, even there, the costs are historically high.

Capital Adequacy A capital is a problem for only a select number of banks. Unfortunately, these include many of the nation's larger banks with capital initially impaired by loans to less developed countries and more recently by nonperforming real estate loans.

The FDIC and Regulation The reports of various outside experts and government agencies are not particularly convincing as to the extent of embedded losses facing the deposit insurance fund. Specific unknowns include: (1) how much have real estate values truly declined in markets where there is very little current sales activity, (2) what will be the depth and magnitude of the recession, and (3) what will the federal government itself do to influence banking losses going forward?

The likely source of the large level of funds needed to deal with this crisis seems to be the banks themselves. However, a gradual increase in deposit fees subtly, but dramatically, changes the ultimate risk profile of many banks. This is not necessarily the appropriate policy response since the current deposit insurance shortfall can be attributed to defects of public policy, rather than to the misdeeds of the banks that are likely to bear the brunt of this burden.

A fundamental problem with the banking system is overcapacity. Various capitalization schemes for troubled banks -- being described in the press -- would appear to prevent this problem from correcting itself.

The relaxation of existing regulatory requirements can be extremely dangerous over the long term, regardless of how comforting it may prove over the near term. Banks with very little capital on a true economic basis have a genuine incentive to adopt a higher risk profile.

Credit Availability As would be expected, banks are taking a more prudent approach to lending, given the slowdown in the economy and

the burden of debt that is evident in all sectors. The decline in bank lending has reflected primarily a reduction in the demand for funds by creditworthy customers. Once the economy bottoms out, credit will be available.

The Role of the Regulators There is no doubt that some of the examination reports in 1989 and 1990 came as a shock to bank managements. In our view, the examinations were recognizing erosion in real estate values that had been occurring for at least two years and had not been properly identified by bank managements. Bankers in areas such as Texas and the Southwest generally state that, while initially they felt examiners were too tough, in retrospect the examiners had a better feel of the markets than did the banks.

Recommendations on how to bring more investors and capital into the banking system The most important message from the investor community is its strong report for the bank equity capital requirements currently imposed by regulators and endorsed by Congress as a benchmark in FIRREA. Similarly, investors favor the continuance of a strong regulatory process. Regulators should continue their efforts to implement consistent standards for loan classification and other disclosure or examination items.

Recommendations and observations on various structural changes:

Barriers to nationwide interstate banking should be removed.

Proposed changes in bank powers will have little impact on bank profitability overall, and permitting industrial companies to invest in banks will only bring marginal amounts of capital into the industry.

The "too big to fail" doctrine should be the responsibility of the Treasury and the Federal Reserve, if Congress makes the policy decision that preserving select banks is in the national interest. Simply discussing the possibility of abandoning the doctrine should bring increased discipline into the marketplace.

Regulations, initiatives, policy directives and so forth should be directed at the problems of all banks, not just those of the New York banks.

The insurance of accounts should not be tinkered with at the present time because of the possible adverse effect on depositor confidence.

The use of brokered deposits should be controlled.

Major new nationwide entities will emerge and be the dominant forces in U.S. banking in the decade of the '90s. These will be banks that are strong in capital, core funded, and will be largely responsible to local needs.

STATEMENT OF JAMES GRANT, EDITOR, GRANT'S INTEREST RATE OBSERVER, NEW YORK, NY

Mr. GRANT. Good morning, Mr. Chairman, Members of the committee.

Perhaps I could begin by attacking the Chairman of the Federal Reserve Board, specifically in the framework of the question you just asked Mr. Weiant. That is, is there something perhaps bigger than real estate. And to the end of answering that, I would like to hark back to about a decade ago when the banking problem was defined and delineated as the problem of Braniff Airlines and Poland.

Subsequently, that definition was broadened to embrace International Harvester Corp., and at length, some classes of real estate, but it was never seen for what it was, which was a problem in the art of lending, and not the problem of an asset class.

Real estate constitutes the greatest irony that we could imagine for the national banking system. The first and the greatest heresy for a commercial banker is the mortgage. Bagehot wrote about it in the mid-19th Century, and McCulloch, our first comptroller of the currency, wrote about it in the mid-1860's.

The National Banking Act was absolutely ironclad in its opposition to real estate lending. And gradually, by degree, starting with the Federal Reserve Act of 1913, these limitations were relaxed and, at length, removed.

Mr. Greenspan, a week ago, uttered what would be considered by any other generation but ours to be the rankest heresy imaginable. He said, to the National Association of Manufacturers that banks are in the business of making illiquid loans. He said that is their business. Well, that is a description of their business, but that has historically not been their business. Their business has historically been that of husbanding the depositors' money until such time as the depositors wanted it back again.

It seems to me that seen over the long sweep of time, three trends have been working in our credit and banking system. One has been the popularization of credit or debt. Time was where you couldn't get a loan. Today, you can't not get one.

Citibank did not get into the business of making consumer loans until 1928 when the attorney general of the State of New York pleaded with it to do so to fend off the loan sharks. That was how badly some very solvent and very bright bankers underestimated the capacity of the working man to pay his bills.

The second trend has been the socialization of credit risk, which has been creeping gradually, certainly since the 1930's, but even before that. The socialization of risk was a most seductive and appealing proposition. The irony of legislation is that problems are perceived and addressed after they culminate. And after the banking system was purged of credit risk, after bankers were terrified and immobilized by the fear of loss, it was then that we undertook to insure deposits. And it was, by and large, a free enterprise, because no one would make a loan.

In the 1930's, there was something called a 13(b) loan in which you could get the Federal Reserve to guarantee 80 percent of the principal and you, the commercial banker, would get 6 percent

when treasury bills were yielding 1 percent. That program would not fly because the bankers would not make the loans. So it was at this moment of absolute immobilization that the Government undertook to guarantee the deposits of the people. Naturally, no such insurance was needed at the time.

At length, those traumas of the Depression were laid aside, forgotten.

It was at the period of inflation when the last, presumably, banker had left to go to Palm Beach, that is, the last of the bankers of that generation of the Depression had left to retire, when the deposit insurance ceiling was raised to $100,000, and we were off and embarked on the 1980's.

It seems to me that there has been a third trend, which is the systematic elevation to orthodoxy of financial heresy.

Mr. Greenspan uttered the heresy of illiquidity. He gave this, without a footnote, as if it were received opinion. Banks should be making illiquid loans because, presumably, the taxpayers are there to return the money the depositors might want in a hurry. But there have been much greater heresies afoot, and these have taken the form of orthodoxy.

One is, as, Mr. D'Amato seems to suggest, that the Fed has a freehand in interest rates. That it should lower rates because lower rates are better than higher rates. On February 1, belatedly, the Fed lowered rates, because it had to. On January 31, however, the Bundesbank raised rates because it chose to.

It's a world economy and a world credit market, and the United States is an uncreditworthy country with respect to its institutions. We are not having these hearings, I think, now in Germany.

So it's not as if the Fed, by lowering rates, could thereby magically exorcise these demons that we now face. What is wrong with boom times is the legacy of the boom. People make loans they might not have made, had their heads been clearer. There is an unwritten law in Wall Street that every good idea must be driven into the ground like a tomato stake. And that law has taken on proportions greater than might have been imagined under the regime of socialized risk.

It is a sorry commentary, but an absolutely factual one, that our greatest bank, Citibank, Citicorp, the holding company, is in a worse way today than it was in 1931. The people running Citicorp have IQ's, I'm sure, as formidable as those who ran the bank in days gone by. What they have that their forbearers did not have is the confidence, the arrogance, perhaps, that behind them stands amassed, voters and taxpayers of this republic.

In New York City, there is a bank called the Merchants Bank of New York with assets of approximately $650 million. It shows ratios of equity to assets of 10 percent. It makes loans to diamond dealers, to textile merchants, to printers, and it gets its money back.

I am a small businessman in New York City and I have an account with one of the banks that could not carry the Merchants Bank's attache case, figuratively speaking. Now my dilemma, as a depositor, is whether I deposit my money with this bank that deserves to succeed, but might not, because banking, as the other witnesses have indicated, is a highly leveraged and highly volatile line

of work. Now, do I deposit my money with the Merchants Bank which is worthy of a depositor's faith on merit, or do I deposit with a bank that you, us, will not allow to fail? I make my living as something of a calamity howler and as a preacher of orthodoxy on Wall Street, but I confess to you that I do not deposit my money with the Merchants Bank of New York. And I think until such time as we allow safety to return as a franchise in banking, until we reward prudence, and until we allow failure to take its course, that we legislate in vain, and we reform without effect.

[The complete prepared statement of James Grant follows:]

TESTIMONY OF JAMES GRANT BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
FEBRUARY 21, 1991

Mr. Chairman and members of the committee: I am honored to be here this morning to discuss the banking predicament. I would like to begin with a proposition: what troubles banks is more than banking. Banks are in decline, but so, too, are many thrifts, insurance companies, corporate-bond issuers, states, municipalities and families. The United States Treasury is not what it used to be. It is important to recognize that credit itself--the capacity of debtors to pay on time and in good money--is on the downgrade. I think that this decline is a direct result of the socialization of lending risk.

Wall Street is in the business of selling securities and its capacity to rationalize events in the interest of closing a sale is unbounded. In the 1980s, the apologists for banks insisted that there was no general credit problem. There were specific credit problems at International Harvester, Braniff or Brazil. There was the isolated regional problem of Texas. However, it was fashionable to contend that there was no deterioration in credit itself. Now we know that there was.

Another hopeful argument is circulating today. It is that banks are obsolete and their decline is therefore immaterial to the health of the national economy. In effect, the theory goes, when banks stop lending, lending no longer stops. Finance companies, money-market mutual funds and loans refashioned as bonds are supplanting conventional bank credit. There is a half-trillion-dollar commercial paper market. Nevertheless, it seems to me, banks are still near the center of things in credit. Even when they do not lend directly, they promise to lend conditionally. Such promises (known as backup lines of credit and standby letters of credit) undergird other markets, notably the vast commercial-paper market.

It was no accident, I think, that the boom of the 1980s carried farther--to greater excess--than any prior American debt expansion. Federal banking policy prolonged and sustained it. No general run on illiquid banks burst the bubble of real-estate lending. Except for isolated cases, the extraordinary growth in bad lending went unchecked by the uninsured depositors of the unsound banks. Banks competed in interest rates, service and convenience but not, in general, in safety. Indeed, a conservative bank was hard-pressed to compete against a reckless bank. In the Pujo hearings in 1913, George F. Baker, a leading New York banker and contemporary of J.P. Morgan, tried to deflate the then-popular notion that the banking system might be monopolized by evil or incompetent men. "I do not think bad hands could manage it," said Baker. "They could not retain the deposits nor the securities."

Today, that remark would have to be revised: "They could not retain the depositors nor the securities without government assistance." In the 1980s, the public came to accept that one insured bank deposit was as good as another and that the biggest banks had become virtual wards of the state. In those circumstances, banks logically took risks. Believing that there would be no run, they lent against illiquid collateral. They particularly favored real estate.

The destruction of credit turned out to be a highly profitable campaign. The wrecking of the Texas banks was a bonanza for the Texas real-estate industry. The bubble in junk bonds contributed to the rise in stock prices. The piling up of dollar balances overseas led not to a "dollar crisis" of the kind we had in the late 1960s but to a slow-motion devaluation that nobody in America, even now, seems to mind very much.

In twentieth-century finance, one generation's heresy has tended to become the next generation's orthodoxy. Citibank originally got into the consumer lending business because the New York State Attorney General asked to; the year was 1928 and the reason was to suppress loan sharking. Solvent, intelligent bankers had grossly underestimated the financial capacities of ordinary people. In the 1980s, on the other hand, nobody underestimated anything. The decade was the culmination of the long-running tendency to nationalize the cost of bad lending.

I believe that safety should be restored as a competitive feature of the banking market. In the Panic of 1907, Hetty Green deposited $1 million in a noninterest-bearing account at Chemical Bank in New York because of the Chemical's unsurpassed reputation for soundness and liquidity. With the advent of deposit insurance and the too-big-to-fail doctrine, however, the economic value of safety has been devalued. Banks should be allowed to succeed as well as to fail and the consequences of those results should rest with stockholders and depositors, not with the taxpayers.

To return to the state of credit: The troubles in banking are indicative of broader trends in other markets and institutions, in this country and abroad. One revealing example is the deterioration in the quality of corporate bonds.

W. Braddock Hickman, the great scholar of corporate-bond credit quality, once posited a truism. Based on research into the first four decades of this century, he found that downgrades of debt issues tend to predominate in bad times and that upgrades tend to characterize good times. Now Moody's Investors Service has amended Hickman and brought him up to date. According to a new study of the two decades, 1970-1990, downgrades predominate year in and year out. They have outstripped upgrades in every year since 1975, boom or bust. Furthermore, the ratio of downgrades to upgrades has been on the rise.

In a new, companion study, Moody's found a similarly disturbing rise in the trend of corporate-bond defaults. For instance, it discovered that the default rate for junk-bond issuers rose to 8.8 percent in 1990 from 5.6 percent in 1989. According to Moody's, they were the highest consecutive annual default rates on record.

If the consensus of economic opinion is right, the current recession, which began in 1990, will be short and mild. All the more notable, then, that the principal bond rating agencies downgraded ten times as many banks as they upgraded last year. "I can't think of any comparable year in banking," Michael DeStefano, a vice president of Standard & Poor's, told the American Banker. "There's never been anything like this."

It is easy to pick other examples in other branches of the credit markets. For instance, the rate of filings for personal bankruptcy in the United States has been climbing since 1984. For 15 years, the number of bankrupts per 1,000 Americans had been 1.4 or less; near the end of 1990, the rate exceeded 2.8.

Nor are banking and credit problems unique to the United States. On the authority of Reuters, there are asset-quality worries now in Indonesia. The well-known jitters in Australia are strikingly similar to our own. In recent days, two leading overseas banks have been stripped of their triple-A status by American bond-rating agencies: Toronto-Dominion Bank and the Industrial Bank of Japan. On February 15, the Financial Times of London reported that mortgage-lending institutions in Britain last year repossessed 43,890 houses, three times as many as in 1989 and the most since records began in 1979.

So the American banking dilemma does not exist in isolation. Domestically, it is of a piece with the thrift crisis and with the fact that some debt obligations of the Equitable Life Assurance Society of the United States (our third-largest life insurer) recently were quoted at a junk-bond yield, 13 1/2 percent. It is related to the chronic deterioration in the credit quality of corporate bonds (investment-grade and junk-grade alike) and to the weakened state of the federal finances.

As for the Federal Reserve System, bulwark of the nation's banks, it shows capital of approximately $5 billion. It has assets of $320 billion. Thus, its ratio of capital to assets amounts to 1.7 percent, well below the standards set for the banks that it regulates. If the Fed were ever to examine the Fed, it would have some explaining to do.

It will be said that the Federal Reserve is a regulatory body and is no more a bank, in fact, than the FDIC or the Interstate Commerce Commission. However, the Fed was established in the image of a bank and its undernourished capital account is a symbol of the reverse-evolution of American credit. Since the 1930s, we have turned away from liquidity and individual responsibility toward illiquidity and collective responsibility.

An earlier banking reform is a perfect symbol of the direction of change. In 1935, the rule stipulating double liability on the common shares of national banks was rescinded. Under this convention, the owner of equity in a failed bank stood not only to lose his entire investment but also to be assessed for up to 100 percent of the par value of his stock to meet his bank's debts.

The advantages of reform are obvious: we no longer have many bank runs and the equity-raising ability of banks is not inhibited by the fear of a capital call on the stockholders (it is inhibited by other things, but not by that). On the other hand, we do have great snowballs of debt that we roll ahead of us through good times and bad. Runs, and the threat of runs, constituted a check on the tendency of bankers to overexpand.

In the run-free 1980s, half of all the office space ever built in the United States was constructed, and banks financed most of that activity. From 1980 to September 1989, according to a new study by

Moody's, banks increased their commercial real-estate mortgage lending at an annual rate of 12 percent. Commercial real-estate lending by life-insurance companies grew at less than half of that rate. "Given that bank commercial real-estate lending growth exceeded life insurance commercial lending by a substantial margin," Moody's commented, "it is clear that the banking sector was, during the 1980s, increasingly lending without permanent takeouts in place from the life-insurance industry. The growth in more-speculative construction lending without the discipline of pre-arranged permanent financing commitments was a key factor that has caused the supply/demand imbalance to get as large as it is now."

In 1975, one of the blacker years for real estate in postwar history, the ratio of commercial real-estate debt to the gross national product reached 10 percent. In 1989, it was 14.3 percent.

Banking--fractional-reserve banking--is a leveraged and volatile business. Very few banks show equity capital of as much as 10 percent of their assets. By definition, though, even those exemplary institutions are leveraged 10:1--for every $10 in assets, they hold just $1 in equity. Lesser banks are leveraged 20:1 and higher. The margin for error in any bank is thin; in the weaker institutions, it hardly exists at all.

Capitalism is a system that tends to correct error rather than perpetuate it. Banks, by the nature of their leverage and of their compact with depositors, must be especially quick to rectify mistakes. The commercial banking tradition therefore emphasizes liquid assets, i.e., loans and securities that can be quickly "realized," or turned into cash. It emphasizes prudence and conservatism over flash and innovation. The money belongs to the depositors, and they might want it back again.

From the time of Woodrow Wilson, the thrust of government policy has been to lessen the cost of illiquidity. The Federal Reserve has discounted loans and the FDIC has protected depositors. Much good has come from these arrangements. As the Depression faded from memory, however, the welfare state of credit diminished the franchise of safety and created the circumstances we now regret: a banking system successively freighted with Third World loans, real estate loans and loans to highly leveraged corporations. It is the taxpayers' system.

And on this score, too, yesterday's heresy is today's received truth. A couple of weeks ago, Alan Greespan himself said the formerly unspeakable. "Commercial banking is the practice by which you make illiquid loans," he told the National Association of Manufacturers. "That's the business. You make loans to individual organizations on unique properties in special areas and the basic purpose of the loan is not to get paid back immediately or to sell the loan, but to essentially carry the loan over a period of months or, sometimes, years . . . . "

The Chairman was not making the case for bad lending, but he was endorsing the status quo. He did not draw the connection between the real-estate lending debacle, on the one hand, and the devaluation of safety in banking, on the other. He did not urge a return to liquid banking in the interest of preserving and restoring the Bank

Insurance Fund. The illiquid state of commercial banking is the condition we have, but it is hardly the natural condition. It is the subsidized one.

All these issues are related, it seems to me. In 1961, a bill to raise the limit on real-estate lending for national banks came up before Congress, and Henry S. Reuss, Representative of Wisconsin, reflected on what it meant. "Before we had deposit insurance to protect depositors in banks," the Congressman said, "there was a great deal to be said, it seems to me, for the proposition that we should not let banks put too much of their lending power in long-term relatively frozen assets like long-term mortgages on homes for 15 or 20 years."

The more secure the depositor in the safety of his money, the less guarded a banker can afford to be about the condition of his balance sheet. Thus, the more prone the system becomes to unchecked error.

The American banking system must be made safe for the taxpayers as much as for the depositors. To that end, latter-day Hetty Greens must have grounds to worry about the safety of their principal. They will have too little reason as long as too-big-to-fail is the law of the land. Over time, this statist prop should be kicked away.

At the start of my testimony, I tried to put the American banking problems in the perspective of the world's credit problems. For reasons that none of us fully understand, the quality of credit around the world is suffering a measure of decay out of all proportion to the cyclical decline in business activity. There is nothing that we can do about the Japanese stock market or the British real estate market except to understand that the deflationary forces bearing on American markets are global ones.

I also promised to answer the analysts who wonder what we are doing here this morning worrying about an obsolete industry rather than celebrating the success of a vibrant and growing market, e.g., the commercial-paper market. I would like to conclude by observing that behind virtual every corporate commercial-paper issuer stands a bank. The purpose of the bank is to lend in case the commercial-paper market should ever unexpectedly shut down (as it did briefly to marginal issuers following the Penn Central bankruptcy in 1970). It should be noted that the paper market, now more than ever, is the province of the blue-chip corporation, not the entrepreneurial one. It is not the successor to the banking system but an adjunct to it. What gives me pause about the paper market is the deterioration of the balance sheets of the banks that have undertaken to lend in support of it. We can be sure that when the banks are called upon, they will be even less eager to lend than they are at the moment.

Banks play a vital role in any capitalist economy. They are too important not to be allowed to succeed. Similarly, they are too important not to be allowed to fail. We must not fail them on either count.

The CHAIRMAN. Thank you.
Interesting, provocative.
Senator Garn?

TOO-BIG-TO-FAIL

Senator GARN. Just on your last point, in getting into the too-big-to-fail, in theory, I can agree with what you say. And look at the deposit insurance system and it's obvious to everyone that, particularly in the savings and loan industry, a lot of loans were made that would not have been made if they didn't say, hey, we can fall back on FSLIC or the taxpayer, whatever.

No doubt about that.

But, on the other hand, you didn't address, in your remarks, about the implications on the system. I can remember when Continental Illinois was in trouble. And the Chairman of the Federal Reserve called me and said, "Senator, will you help me make some calls?"—I was chairman of the committee at that time, and he said "will you help me make some calls to depositors in Manny Hanny, and some of the big banks in New York, because we're afraid they're all going to pull out." Many of them I talked to were.

So I can make the case on the other side of that.

If we'd let Continental fail and done nothing to try and stem the tide, she could have had a ripple effect through several other large money center banks.

So while I can agree, philosophically, with what you say—we've got to allow some failures and lessen this reliance on deposit insurance and so on—don't you have some concerns for the system?

Mr. GRANT. Well, I do, indeed.

And I do not shrink from the notion that the implication of a regime of merit is one of occasional runs with occasional losses to wholly innocent and uninformed people.

However, the cost of the absence of runs is invisible until it becomes undeniable. And its undeniability stems from its size.

Since Continental got in the soup, which was in 1984, we had 5 years in which, as Carole Berger pointed out, astonishingly, 62 percent of new loans have been in an asset class that was not admitted to legality in the national banking system until our lifetimes. Citibank was in business from 1812 to 1960, and it somehow got by without making any real estate loans willingly. It made some, but not many.

So the reach for yield, the high yield period in banking is a very recent one, every year in which we perpetuate the idea that we really allow risk-taking until such time as the risks don't work out, until such time, we continue to roll forward great mountains of illiquid debt. And you only have to look to yesterday's Wall Street Journal to see what an embarrassment this is to any of us who pretend to champion and defend enterprise and markets.

NWA, this airline that made a great splash by borrowing up to its chin a couple of years ago, is now whining to the taxpayers for relief because it can't meet its fixed charges. Now, why should insured depositors be helping to leverage enterprises that then come to Congress to ask for relief? It seems to me that a lot of the loans that have been made wouldn't have been made had we done what

we should have done years ago. I'm not pretending that it's easy to do, and I'm not saying that it should be done overnight.

Senator GARN. Well, let me stop you there, because I agree with you.

I grew up with a father who never even bought a house on time. His whole attitude was that if you don't have the cash to pay for it, you shouldn't buy it.

So he and mother saved for 15 years to pay cash for the only home they have ever owned.

Now, that's the other extreme.

But that's the environment I was brought up in.

I personally have never had a loan of any kind, except on a house.

At least my father got to me on consumer loans.

Every car I've ever bought in my whole life, I paid cash for.

I don't know what it is to have a payment book on anything.

So I don't disagree with you.

But, still, the fact is we've got to go back and make a lot of changes so that this doesn't happen again.

I've been singing that song of more comprehensive changes for years.

But, still, to get back to the point, there are some circumstances, even if we fixed a lot of things, took away the risk, or if they weren't making the bad real estate loans anymore, I'm still convinced that there are certain circumstances where we can't allow a systemic run.

There are so many little things.

There was a thrift institution in Utah that the press simply reported didn't qualify for FDIC insurance, a fact. They were 2 weeks away from getting FDIC insurance, and there was a run and it wiped that little bank out in less than 24 hours, just because a local TV station said they didn't have FDIC insurance. They would have had it in 2 weeks.

So, do you see what I'm trying to get at, in asking you this question.

Even if we fixed everything and we were rolling along, didn't have the big loan exposure and all of that.

I'm still looking at the entire system, and I've seen a lot of things in the last 15 years that can cause problems that I don't think that we can ignore, and must put a stop to.

In other words, I don't know how to define what "too-big-to-fail" is, or exactly how we handle that.

But I just am saying, in my opinion, there are some situations that I couldn't sit back and say, well, just let it go; that's the way it works, and see a whole series of institutions collapse that didn't need to, because we were standing back from it.

Mr. GRANT. But in the meantime, you have the spectacle of big banks paying dividends, that is, capital that might be retained as earnings, at a time when they are asking for regulatory forbearance. I mean, there are issues of equity on both sides, and they're very difficult.

Senator GARN. Well, I assume you don't have an answer for me, either.

I can't answer my own.

Mr. GRANT. I have a chapter-length answer, but not a paragraph-length one.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman.

I've been reading the history of the great Crash of 1929.

One of the things that strikes me is that what was seen as the pathology of 1929 is now being seen as the prescription of 1991.

Analyzing what happened, things like the fact that banks were too involved in nonbanking activities, and the contribution that that made to their demise was seen as an illness.

Now, we seem to be about to prescribe that as the solution to our current problems.

A sense that I get in this issue is that we have become captive to a box of options that is many years, if not decades, out of date.

And that what we need to do is to try to think more fundamentally about what is the economic context in which the American banking industry is living today and will be living in the future.

And then what does that say about what that system should be.

Some of the aspects of that change are very obvious.

The internationalization of the environment in which we are operating.

Some very basic questions at least that I have about how well the intermediary function is working.

Some of the issues that you have cited relative to changes in the inflationary marketplace, the decline in the relative savings rate of Americans and the increase in their willingness, whether it's as an individual, a business, or a government, to assume greater debt burden.

Unprecedented fiscal deficits at the Federal and now increasingly at the State and local level.

All of those, in my opinion, have fundamentally changed the economic environment.

And we need to take all of those into account in prescribing what kind of solutions we should undertake.

Having made that editorial comment, I'd like to particularly focus on the issue of the intermediary function.

Banks, particularly money center banks, had as their core business, historically, corporate lending.

That area has substantially declined as other institutions have eliminated the intermediary, and have gone directly from borrower to lender for much of what had been the traditional business.

Banks have then sought out new areas of activity and we've seen in a distressing number of institutions in which they haven't made what have turned out to be very good business judgments.

ROLE OF BANKS IN THEIR INTERMEDIARY FUNCTION

Could you comment on your assessment, what is the role of the banks in their intermediary function in the context of other institutions having taken their place for what had been their fundamental business in the past, and the current record of judgment on the ability to select good loans in the new areas in which they have endeavored to operate?

Mr. GRANT. I'll try, and then quickly defer to my colleagues, who are experts in this.

I think there are a couple things to recognize so far as the migration of creditworthy borrowers away from banks are concerned. One is that it began in our lifetime in the 1950's, in the mid-1950's.

And second, it was deplored by the people at Citibank in the teens. There was a flurry in which commercial paper in the corporate bond market began to strip away Citibank's best customers, then. So it is recurring, as well as now seemingly endemic and permanent.

I think what is so hard about the banking business is the circularity of the loss of creditworthiness. As banks in the inflationary age have reached for higher yields, they have seen decay in their balance sheets. As their balance sheets have decayed, they have had to pay higher rates for capital on the free market, as opposed to in the insured deposit market. As they have paid higher rates, they have had to reach still higher for yield, thereby attracting a still less desirable class of borrower. And you can see this so clearly in, for example, Citicorp's business loan portfolio which now has a yield, if memory serves, of 13.5 percent which of course is a junk rate yield. That is not the entire yield on the whole Citibank balance sheet, but their business customers are paying them the junk bond yields as, indeed, are junk bond customers. I think that is the business class that is largely patronizing commercial banks now.

People say, "well, the banking system is expendable because companies can go into the commercial paper market." It's not true because the companies that are borrowing from banks, many of them can't issue paper, which has become a very credit-sensitive market. And as Bill Weiant pointed out, the commercial paper market is undergirded by the promises of banks to lend if they're asked to lend.

So, I'll defer to you, then, Bill.

Mr. WEIANT. Well, I think actually everyone worries a little bit too much about the money center banks.

The money center banks did have a structural problem in the 1950's and 1960's in that they were not able to expand geographically, so they weren't able to follow the normal banking customer, which would have been the middle market company and the consumer.

They also had difficulty in generating core funds because they were restricted.

The reality is, though, that corporate lending to large corporations is a bad business for everyone.

Commercial paper does not make much money for investment banking firms.

They do it as a service, but it is not a big money maker.

And even if the New York banks get back into that business, they're not going to make any money at it.

The fact is, is that large corporations are more creditworthy than anyone who can lend to them, and that's the reason they have direct access to the market.

In terms of the overall intermediation, if you look at the bulk of the banking system today, it's fulfilling its role.

It's lending to middle market companies.

It's lending to consumers.

It is responding, hopefully, to the deposit needs.

I don't think that the banking system, if you look, generally is doing well, if you get away from a limited number of problem banks, and we keep overlooking that.

Unfortunately, a lot of the banks that are problem banks are our large ones.

And we have a fallacy which Carole, I think, focused on, or mentioned, is that we allowed these large banks to try to earn their way out of the problem in the 1980's.

It would have been better to have discipline on the money center banks early on.

If they hadn't tried to earn their way out of the problems, they wouldn't have some of the problems they have now in real estate and HLT, and probably credit problems generally.

Ms. BERGER. Yes.

I agree with Bill, particularly as it pertains to the legal barriers that banks have had.

And it's really inhibited their ability to operate efficiently.

But as an analyst for a lot of years, I have to say one of the things I live by, one of the credos that's written on my wall is, the more efficient a capital market, the less profitable its intermediaries.

That's what efficiency means—the spread goes down because there's a more efficient way to access capital.

And the problem for the banks is that we are over-banked. There are far too many banks. They have not been able to rationalize their businesses because of a lot of legal barriers.

I think that we should encourage an environment where you see mergers, mergers of equals, large banks in intrastate mergers. And that way more of the costs are spread over a larger asset base.

This country, and I don't have the statistics with me, has far more banks than any other country of the world per capita. This has added to the inefficiency of the system. And it has created an environment which encourages risk-taking which in turn, the taxpayers are going to end up paying for.

The CHAIRMAN. Senator Sasser?

Senator SASSER. Thank you very much, Mr. Chairman.

I would say to my colleague and friend, Senator Graham, that I read that book about the great crash, only I had the misfortune to read it in 1983.

So I sold all of my stock just before the market went out of sight.

And I sat on the sidelines there for about 7or 8 years.

That's not to say that the conditions now are worse today than they were then, but I was frightened as long as 7 years ago.

Let me ask this panel this question.

A few weeks ago, I had a conversation with a president of a major regional bank here in the country.

And we were talking about the issue of modernizing the financial system.

And this banker told me, and I want to see if I can quote him pretty accurately, he said, "I would get the supervisory system in and working well, before we inject new risk into the system."

He went ahead to say, "the mistake that you made with the savings and loan was that you added the risk to the system before you had a regulatory structure in place to handle those risks."

He went ahead to say, "the real issue with the viability of the banking industry is not a question of products but a question of the cost that the industry is incurring."

Now, he went ahead to suggest the first thing we ought to do is straighten out the Bank Insurance Fund.

Second, he said, "after we do that, we ought to streamline and strengthen the supervisory role of the Government."

"And then the last thing we ought to do is give the banking system new products and new services."

Now, I get the impression that the Treasury Department is proposing that we do everything at once.

That we straighten out the Bank Insurance Fund.

That we do something about supervision.

And at the same time, we give the new products and services to the bankers.

Now, that may be the right course to follow.

But I'll have to say that my friend's comments trouble me a little bit.

And Senator Graham's observation, I thought, was a good one: that we're now advocating as a prescription to solve our problem the same thing that partially at least caused the problem back in the late 1920's.

I'd be interested in getting the panel's reaction to my banking friend's suggestion about, how to get the insurance fund straightened out.

Then let's get the supervisory role straightened out, before we go on to new products and services.

What do you say about that, Ms. Berger?

GETTING OUR PRIORITIES IN ORDER

Ms. BERGER. In general, I would agree.

I still believe, and I agree with Mr. Grant on this, that the too-big-to-fail doctrine, that is, insuring large depositors, has to be phased out. I wouldn't suggest that we just call it null and void today, because there are tremendous risks to that. But I think that one could devise a plan where it was phased out over a period of time.

For instance publish the list of banks which are deemed too big to fail today; I don't care whether you call it the 50 largest, the 100 largest, and over the next 6 months, we'll guarantee 95 percent of the principal.

And then phase it out over a period of time, so there can come a pricing mechanism back into the system.

Today, not having any pricing mechanism in the system, you have increased the cost of all deposits across the system, and you are forcing the stronger institutions to carry the weaker institutions.

Senator SASSER. That would be a way of getting the cost down.

Ms. BERGER. Well, it's a way of getting the cost down, but it's also a way of weeding out the riskier lenders.

It would help banks price their liabilities more appropriately, and wouldn't cause them to go after risk on the asset side.

If a bank has to pay up for deposits, the banker responds by saying, well, I have to get more in the way of yield on the loan I'm making. And yield is highly correlated to the kind of risks you're taking.

So if you're forcing up the costs of deposits in the system, then by definition, you're forcing banks to put more risk on their balance sheets. I agree with Jim that one of the central issues here is that the FDIC needs to be reformed.

As far as streamlining the supervisory role, I think it can be streamlined. But I don't think that's where the problem exists.

I think that the difference between the FDIC today and the FSLIC is dramatic.

We allowed S&L's to operate under-capitalized for years. The industry was losing money hand over fist.

And as Mr. Weiant pointed out, the banking industry is not losing money.

And as long as large pools of capital are not extinguished very rapidly, you won't have the same kind of problems the S&L's did.

And the regulatory oversight has been fairly good in this industry.

And, as far as new powers, I think that new powers are fine as long as you correct, first, the issue of FDIC insurance.

Until you do that, you are perpetuating the problems of the industry.

You deregulated deposits in 1981 and 1982 by legislation, and yet you continued to insure them.

It's like an insurance company going out and saying, we insure this car today. And all of a sudden, something happens to that driver that changes the risk, but the insurance company doesn't change his insurance at all. Of course that insurer will have more losses.

And that's the problem we're facing today in the FDIC.

Senator SASSER. Of course, as you know, we deregulated the deposits because the bankers said they couldn't keep the deposits in their banks unless we deregulated them.

Ms. BERGER. All I'm suggesting is that when you deregulated, you should have also changed the insurance program.

Senator SASSER. What about the rest of the panel?

Do you have any observations about whether or not we're putting the cart before the horse here, in giving the banks new powers before we get the insurance fund straightened out, or get the regulatory system hitting on all eight cylinders?

Mr. WEIANT. I think you were talking to a very smart banker.

I think he had everything in the right order.

The insurance fund is the most important thing at the moment.

I think the best way, though, to sort of accomplish what they want is to listen to some of the testimony that Mr. Greenspan gave, I think it was last summer, in which he said what we need is the discipline of very strong capital positions within the banks, and we also need very strong regulation.

And those two can go side by side, and that's what the industry really needs.

So I think the key here is not to have any relaxation on the capital ratios.

I think the minimums required under BIS are absolute minimums. They should be significantly higher.

Most regional banks operate with equity capital ratios in excess of those limits.

And I think we also should have very strong, as I say, regulators.

Streamlining the supervisory system.

I think the problems that banks see today is inconsistency.

They see inconsistency between the Comptroller's office and the FDIC.

Quite honestly, a lot of people see inconsistencies within one of the offices, such as the Comptroller's office: who examines them makes a difference.

I gather, right now, one of the major thrusts is to come up with consistency, and that's important.

It would be putting the cart before the horse to grant new products, although, in reading the Treasury's proposals, the way they propose doing it is being done, I think, in a fairly sensible, judicious way, with only allowing banks with very strong capital ratios to get into these new businesses.

They rely heavily on fire walls and also regulation by respective agencies. That seems to me to be very good.

I think the key is that people think that, given new powers, their problems will be over. And that is really where the myth is. It will not be a problem-solver in any way.

Senator SASSER. It could even be a problem-creator.

Mr. WEIANT. It could be a problem-creator, although, again, if you operate these activities in separate subsidiaries and there are firewalls, I think there will be less problems than if it simply were allowed to be done within a bank and it became part of the overall operation.

Senator SASSER. My time is up, Mr. Chairman. Thank you.

I would like to ask unanimous consent that a statement that I had intended to issue earlier be included in the record.

The CHAIRMAN. Without objection, so ordered.

STATEMENT OF SENATOR JIM SASSER

Today we are a Nation in recession. The economic health of the country is suffering, and one of the most critical ailments is the banking industry.

The condition of the banking industry has a significant and direct effect on the economy overall. Therefore, it is in the interest of the country as a whole that we bring back vitality to the banking system swiftly but also cautiously.

The question before the committee over the next several months will be how to do this. There will be many divergent answers offered. As possible reforms come before the committee, I suggest we should pursue an agenda that will solve our most immediate problems but also look to the future.

I am concerned that some of the proposals that are being debated may do too much at once. Specifically, I propose that there might

be a certain order to reform that will be most effective both for the short- and the long-term.

Furthermore, I believe that as a first step we must make sure that the bank insurance fund is sufficiently capitalized. We must ensure that losses to the fund do not present any liability to the taxpayer.

As the debate on structural reform ensues, I believe that a rather simple but important fact should be recognized. That message is that the basis of a strong banking system is confidence. Without confidence people do not place deposits. Without deposits banks do not lend. Without lending there is no growth and the economy atrophies.

I believe that this hearing presents an important opportunity for the members of this Committee to hear the views of the distinguished witnesses and to get some answers. We have seen the Treasury's plan for financial modernization and this panel provides another perspective to look at the immense questions before us. I commend the Chairman for holding this hearing.

Thank you, Mr. Chairman.

BANKS OF THE FUTURE AND FEDERAL DEPOSIT INSURANCE

The CHAIRMAN. Let me ask each of you, if you leave aside for the moment the transition problems of taking today's systems and today's problems through a set of steps to a new system, a more idealized system, and you just think in terms of where we would like to get to—if we can get there—over some period of time, what do you think ought to go in the bank of the future that rests on federal deposit insurance?

If you're going to maintain a federal deposit insurance regime with the taxpayers as a backstop in some kind of a core bank, what should that core bank be allowed to do?

Ms. Berger, what do you think?

Ms. BERGER. I think that one of the failings today, and Jim alluded to this earlier, is a liquidity problem.

I think that you can see an environment where, if you are insuring consumer deposits, that is very important because it provides confidence. Banks are built on confidence. And, when there is no confidence, the bank disappears rather quickly.

And I think that a broad range of products is not a problem as long as careful attention is paid not just to credit policy, which I think is important, but also geographical distribution. Nationwide banking would be a definite positive in helping to spread their risks. So too would be the ability to form larger, more efficient banks. Consolidation of this industry could be very important.

The CHAIRMAN. Well, does anything need to be done? Do we need to have any additional products? There are different ways to view the concept of a core bank with deposit insurance in the future. One is to provide a whole new set of lines of business that one would hope would be profitable and not too risky and not play back in an adverse way on the insurance fund.

There's sort of a polar opposite view that says:

No, let somebody else do that. If you're going to do something in what's called a "bank" with insured deposits behind it, let's make it narrower. Let's make it more like a public utility. Let's have only certain activities go through there.

You've got the Fed using the banking system to the extent that it can as a conveyor belt for credit activities in the economy and making adjustments in those.

But, in terms of the lines of business one could argue that maybe banks, instead of being bigger, ought to be smaller. Maybe, banks ought to do fewer things and then something else that doesn't have deposit insurance. And that may be an affiliate or it may not be next door—does whatever.

BANKING CHARTER

And I'm wondering how the banking charter in your view needs to change, if at all, with respect to what rests on top of Federal deposit insurance.

Ms. BERGER. Well, I don't think it's necessarily the charter.

The CHAIRMAN. It's not necessarily what?

Ms. BERGER. The charter that needs to be changed.

The CHAIRMAN. Yes.

Ms. BERGER. There's nothing inherently wrong with letting banks do commercial/industrial loans, middle market loans, consumer loans, mortgage loans, so long as the deposit insurance system is fixed.

I continue to come back to:

You've got to bring capital market discipline back to the banks through a pricing mechanism.

The CHAIRMAN. Is that a sufficient business charter though? I guess the issue that I'm raising is that you can define a bank anyway you want. We can have a bank that does everything under the living sun, or we could have a bank that's limited to certain things.

Ms. BERGER. Well, what you're suggesting is basically bringing that——

The CHAIRMAN [continuing]. Is the fact that it's deposit insurance.

Ms. BERGER. Well, you can come back and re-create what existed in the 1930's—insured deposits with a cap on market rates, and limiting the lines of business.

I don't think that's the problem. I think that what we've seen is the non-financial institutions have grown and prospered, but their costs are fixed by the capital markets. And that's not something that banks have had to live by.

And it hasn't led to prudent lending. I think that's what we've seen.

So, if you want to build a firewall, as Mr. Weiant said, to protect yourself against the problems that are inherent in investment banking, that would be fine.

But, if you could bring back the pricing mechanism to the large deposit, that, in and of itself, will force bankers to choose less risky loans.

And by natural selection, you will achieve what you are suggesting you need to do by charter.

The CHAIRMAN. Mr. Weiant, let me try to pose the same question to you.

I'm interested, again, if you could take a jump into the future. I want to start from the premise of:

What rests on top of Federal deposit insurance?

I want to have us all put on our citizen clothes and say, if we're going to stand behind a deposit insurance system, and we may have to take a big hit in the future—as we have now in at least the case of the savings and loan industry—what kind of institution should operate with our guarantee?

And what's in, what's out?

And I guess what I'd like to get is a sense of what should be the core activities that we ought to see as being connected to and worth being connected to deposit insurance?

Mr. WEIANT. Let's say, basically, what we have today is what should be part of the core bank going forward. Again, I think you have to divide the banks between the money center banks, as I see it, and the rest of the banking system. And I'm sure you're going to have a lot of very successful smaller and regional banks here testifying as to how they make money.

Basic banking today is, if you can stay away from loan losses, is a very profitable business. There are not that many industries that can make 12–15 percent on equity consistently with relatively small year to year variations, and growing, you know, maybe 5–10 percent a year.

It's a good business if they stick to the business and if they don't have problems.

The difficulty with the core bank concept, which at different times has been proposed, is mainly what it would limit the banks to do—what they could do on their asset side. And that gets into another form of credit allocation, as I see it.

It would say that consumer loans are good and HLT loans are bad. It would say that middle market lending is good and construction loans are bad.

I'm not sure that that should be done by having a, quote, "core bank" which can use insured deposits to do something and you'd have to do everything else through another bank, which would be funding itself independently.

I agree with Carole. I think that, basically, extending credit is the function of the banks, and I wouldn't be making significant restrictions on what they could do on the asset side as it relates to lending today.

And so you get into some of the newer powers initially, such as securities underwriting. Initially, I think that should be done in a subsidiary. You see how it goes and maybe, ultimately, it can be folded back in as a subsidiary of the bank.

I don't think we want to broaden necessarily the powers of the banks and what's being done within the banks today until we get, you know, the insurance fund improved and the supervisory system also streamlined.

The CHAIRMAN. Mr. Grant.

Mr. GRANT. We might look at it another way and ask:

How could a bank make money by not lending?

In other words, we can agree that there are times when lending is not prudent. There are times when one was to have done in ret-

rospect exactly what this Yankee featured in Wall Street Journal the other day from Massachusetts did, which is not to lend.

In what financial environment can you as a banker make money by being liquid? And I think the answer to that is a very low inflation and low interest rate environment, such as we had for almost every year of the life of this country up until about 15 years ago, 20 years ago.

So I think that the fundamental consideration for banking is the capacity of banks to make a return on their capital by not taking risk.

Now, to make allowances for the financial environment in which we operate, we have had since the 1930's expedience. We had something called the Postal Savings System for a while, which was a place you can go and make a deposit and be outside the banking system altogether. It seems to me one modern adaptation of that might be to have a window at a bank where you could go and get the T-bill rate. And you would be outside the banking system so far as the fractional reserve risk of it and then you wouldn't have to go into a post office.

The CHAIRMAN. Well, you can sort of do that. You can buy a Treasury instrument through a bank. I mean, that's a little more awkward way, but that option is open to you.

Mr. GRANT. I'm looking for a way to get away from deposit insurance, which I think is one of the roots of the evil. I think the deposit insurance system leads you into all sorts of regulatory pronouncements as to which asset class are desirable, which aren't, and so forth. And none of us is wise enough I think to see ahead of time which is going to be the best line of business in the future. It's a very rare piece of foresight to see that. You know, before the reforms of the 1930's, there were a lot of banks that made a good living by lending in a spread. And the way they did that was by cultivating a reputation for safety that could attract demand deposits for nothing. That wasn't the law. In New York City, it was the custom of the Clearing House Association, which was kind of an oligopoly. But, it was not the law. You didn't have to pay for deposits, demand deposits, because you were a safe place in which to put them.

So, a bank like Chemical, which was a fabulously safe place, attracted a million dollar deposit by Heddy Green during the 1907 panic because it was the place to go to be safe. And until you can——

The CHAIRMAN. It's better than his mattress.

Mr. GRANT. Yes. Until you can make a living by being safe, I think you are going to have these terrible distortions and these terrible debt bubbles. And I think the way to make a living by being safe is to be permitted to do that, is to have an interest rate environment which you don't pay very much for deposits because you have solved inflation and, you know . . . I'm afraid there's no magical elixir to this, but I think that's what you have to have.

The CHAIRMAN. Well, I think, you know, it would be nice to get back to that sort of beatific state. I'm not sure we're going to do that in the world in which we live. I'm afraid we're going to be compelled to try to come up with some pragmatic adjustments on the margin here.

And I don't see us withdrawing deposit insurance. And I think, if we did today, we probably would bring upon ourselves the crisis that we're worried may be coming anyway.

Mr. GRANT. Well, we certainly wouldn't do it precipitously. We could keep deposit insurance in for a certain class of depositor. We could keep deposit insurance in for a certain class of depositor. We could keep the $100,000 in. But, we wouldn't, with a wink and a nudge, pretend that we have undertaken to socialize risk in New York City Clearing House, which is really what we're doing now.

The CHAIRMAN. Let me yield to Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

COST SAVINGS FOR MULTISTATE FINANCIAL INSTITUTIONS

Ms. Berger, in your written testimony, you noted a cost savings for larger multi-State financial institutions could be enormous under the Treasury's proposal for interstate branching.

In view of the impact of such a proposal on State tax revenues and regulations, can you tell me specifically what these cost savings might be for the average multistate bank?

Ms. BERGER. No. Unfortunately, I can't. The bankers themselves have been unwilling to try to quantify the number. Suffice it to say that the greater the number of States a bank operates in the greater the savings, First Interstate operates in 13 States—therefore, the cost savings relative to their asset size would be much more than a bank that operated in one or two States.

It would remove layers of expenses that only exist because of the State laws.

Senator ROTH. What would it do to State revenues?

Ms. BERGER. I cannot even begin to look at that issue.

Senator ROTH. Any other of the panelists? Any idea?

Mr. WEIANT. I don't know.

Mr. GRANT. Sorry, Senator.

Senator ROTH. As to what the cost to the State in revenue would be? Multi-State?

[No response.]

Senator ROTH. Let me ask you this question. Since the fallen state of real estate has been a significant factor in the problems of financial institutions, is there anything Congress can do to help restore the value of real estate?

I think one of you in your prepared material talked about the 1986 tax legislation. And there are those in the real estate business who feel the collapse of prices is partly due to the change in the tax laws with respect to passive treatment, to the capital gains, to the investment tax credit, to depreciation.

Is there anything we could do taxwise? Now, those changes were made, of course, in part to avoid shelters. The concern that many real estate projects were developed to take advantage of the tax laws, tax shelters rather than because of the market.

But, now some of the people are arguing in the real estate business that some of those changes were not beneficial and should be reversed.

Do you have any feeling on whether there's anything Congress could do to help restore some of the value in the real estate business?

CAN CONGRESS HELP RESTORE THE REAL ESTATE MARKET

Mr. WEIANT. I'm not an expert on business or real estate. What we heard from people is that they allow them to take losses in real estate and offset it against income in other areas, that you would bring in a substantial amount of new investment into the industry and it would help, in part, dispose of some of the properties held by the RTC.

That might be a good solution for a current problem.

But, the question is:

Does it create further problems?

One of the reasons that there is too much real estate and too much office building was, in large part, because of the tax laws of the early 1980's. So it's a pendulum here going back and forth.

I would hope that the tax law wouldn't be changed, although the knowledgeable people we talked to in real estate feel that this is what should be done if you wanted to do something to alleviate the problem.

Mr. GRANT. On a slightly different variation of that, perhaps Congress might look at allowing individuals to deduct losses on real estate against other gains. As it is, if you sell a house now at a loss, you are stuck. And I think that that law was written at a time when the thought of taking a loss on a home was almost physically impossible. It could not be imagined. That now is all too real a problem.

MONEY LEAVING THE BANKING SYSTEM

Senator ROTH. That is an interesting observation. I would direct this question to all of the panelists.

Would depositors' money leave the banking industry if the Treasury proposals stayed long-term goal of reducing the deposit insurance to a maximum of $200,000 was adopted?

And let me ask you the same question with respect to broker deposits. If they were outlawed, as proposed by the Treasury, would this money leave the banking institutions and cause problems of liquidity?

Ms. BERGER. Part of the problem in studying the issue is that not even the FDIC has a good measure on how much of the uninsured deposits are held in individual accounts and how many are in brokered accounts. Definitionally, they don't have that kind of breakdown available.

So, part of my comments are not based on anything that you can prove. But I do think it would cause firstly some exiting of bank deposits by individuals out of the banking industry. It is very easy just to go down to the Federal Reserve and open an account and buy Treasury bills if you get nervous about the banking system.

And as far as brokered deposits, I think that you would see an outflow. You might even be starting to see—American Banker this week ran an article that there is this silent run on banks. Individuals have to be natural concerned that they might have deposits in

a bank which will no longer be insured if the Treasury's proposals are enacted.

So, the answer is, as far as brokered deposits, I think they will be redistributed into the strongest names in the system—into the Morgans—and out of maybe the Chases. But, they may not leave the system.

As far as individual deposits, they may leave the system.

Senator ROTH. Any comment?

Mr. WEIANT. Well, I think what they should do is improve the health of the system before they start making changes in deposit insurance limitations.

Once the public is convinced that the banking industry is healthy, that's the time to begin to make some changes. There are many different kinds of forms that the limitation could take.

If people were confident in the system, they wouldn't worry about whether it's a $100,000 or $200,000, or whatever.

Initially, I think, if the changes were made today, I think there would be money leaving the banking system. I think we all just focus on wealthy individuals supposedly having this money, but there's a lot of problems for companies that have checking accounts; it's charitable institutions that have funds on deposit. It would create significant problems for them.

I also think that, in doing this, you have to be, you know, the question of what happens if a pension fund has a deposit as an insured, as one deposit, or can it be allocated to all of the members of the pension fund?

And also I think there should be some strengthening as to what, you know, restrictions on what money market funds do, and things like that.

But I think there would be funds leaving the system.

The CHAIRMAN. You know——

Senator ROTH. Go ahead.

The CHAIRMAN. No. Were you finished? Excuse me.

Senator ROTH. I'm fine.

The CHAIRMAN. I want you to continue if you have something else. I'm sorry.

Senator ROTH. I didn't know whether the third panelist might want to make any comment.

Mr. GRANT. Mr. Roth, I can't add much to what Mr. Weiant said.

Senator ROTH. I'm fine. Thank you, Mr. Chairman.

The CHAIRMAN. Ok. Thank you, Senator Roth.

As we grapple with this, and I appreciate the discussion that we've been having here this morning, there are so many things in play at the same time that it's very difficult to freeze the frame to capture reality and sort out all of the different cross-cutting elements.

And from that then make an analysis as to what we want to do differently, how we want to do the restructuring and how we go about doing it step by step, and how we get from here to the Promised Land if we can define "The Pomised Land," without unhorsing ourselves on the way.

One of the concerns that I have is what I'm increasingly reading about and hearing about, that people don't need to leave their money in the banks. And we don't particularly want a lot of people

to go take their money out of the banks right now. That wouldn't help the problem very much.

The answer to how we make these adjustments in a big, complex system that's beset with a variety of problems is not altogether clear. That may be the understatement of the year.

I'm very much concerned about the question of how much we can bite off at once in terms of a massive set of changes that we just sort of put in and hope that it works and takes us on through this difficulty.

I think this is one part of the system that we can't make a serious error in dealing with. We're going to have to make sure that what we do works and maintains a certain stability as other changes come, so it can be absorbed in an orderly way.

SEVERE RECESSION AND BANK FAILURES

Having said that, if the recession proves to be worse—and Ms. Berger, you and your folks are predicting a worse recession scenario they might fail and, empty out the FDIC fund, say, within the next 6, 9, 12 months? I'm not trying to peddle that alarm. I'm trying to get a measurement from the outside as to whether or not we've got candidates that are close enough to the edge that, if we get a little more perverse situation here, we could find that we have some big casualties. How likely might that be, Ms. Berger, if this recession becomes more difficult?

Ms. BERGER. Our projection is for an "average" type recession. If it's far worse than that, there's always the possibility of large bank failures. It becomes an issue of confidence in individual banks and confidence in the system.

Large banks don't tend to fail purely because of their loan problems but because they can't fund themselves any longer. Therefore is it possible.

The CHAIRMAN. Do we have some banks that are close to that now, by your analysis?

Ms. BERGER. How do you define "large banks"?

Among the 50 largest?

The CHAIRMAN. That would be a good definition.

Ms. BERGER. There would be probably one or two.

The CHAIRMAN. Only one or two?

Ms. BERGER. Unless you had a horrendous credit cycle.

The CHAIRMAN. Yes.

Ms. BERGER. But, it could happen. The liquidity problems can happen very rapidly. They can start on rumor. We've seen that recently there's been a rally in bank equities as interest rates have come down. There may be a window up opportunity that some of those banks are able to issue more equity, which would forestall any kind of problems.

So, when you ask me are there any, I must say: yes, there are a few, one or two—maybe three—that are in a precarious enough position today. It will depend on how much more credit deteriorates. Even if the economy rebounds in the second half; the credit cycle won't crest until late this year, early next year.

And so, given the level of problems today, yes, there could be a couple of names. But, the question is:

In what kind of environment does it come?

How does it scare people?

If rates are declining and the economy is recovering, maybe it won't scare those investors/depositors and cause a liquidity run on one of those large banks.

So it really depends not only on their condition, but the perceptions of the environment at the time it happens.

The CHAIRMAN. Mr. Weiant.

Mr. WEIANT. Well, closing of large banks or even semi-large banks is the least desirable alternative. I think, today, you have to look at it in three ways:

Is the bank illiquid?

Is it insolvent?

Or, is it simply not meeting sort of minimum capital guidelines?

In terms of liquidity, most banks in the last 5 years have essentially become core-funded. Their dependence on large denomination CD's and even at the holding company level, their dependence on commercial paper has been reduced substantially. And the banks that we deal with have done an excellent job of shifting this mix.

Since there's a lot of liquidity in the system at the present time, I am less worried about people losing confidence in a bank and withdrawing funds and having a liquidity squeeze.

In terms of being insolvent, that's also less likely, as we see it. What we see is the principal problem today is some banks probably cannot meet the minimum capital guidelines.

Our suggestion there would be not to close those banks, but to keep the banks open even though they were not meeting the minimum.

I think that the regulators should take very strong action though. That would include things such as removing managements. It would put more onus on the boards of directors. It would mean early intervention. It would mean merging of banks without going through some of the normal process you might go through of getting shareholder approval.

And also it would require each of the banks to have some plan for improving their capital.

I think, if that were followed, there would not be the need even under a more severe recession for the closing or failure of a large number of banks, which, obviously, would significantly impact the economic recovery.

The CHAIRMAN. Mr. Grant, did you have a thought?

Mr. GRANT. I think that there is, in fact, a real possibility of there being a large bank or several in difficulty, even without the recession being very severe at all. Let's not forget that credit difficulties have been piling up for sometime without there being any recession. The Junk Bond market got into trouble in 1989, and bank difficulties have been piling up for years. Already in New York City, two big banks are rated in their commercial paper rating P-3, meaning outside the pale by Moody's Investor Service, which is extraordinary. When Bill says the banks are becoming core-funded, I think what he's saying, in effect, is that they are becoming increasingly funded with the taxpayer guaranteed funds and less and less with the capital market funds, the capital market being rather more discriminating.

I think as it is we can't shrink from the fact that our biggest bank, you know, and what is billed as the only global bank, Citibank—Citicorp—has the commercial paper rating, at least by one of the agencies, that is lower than that which is eligible for purchase by money market mutual funds according to the SEC's new guidelines. It's not a very pretty fact, but it is a fact. And I see nothing in the near-term outlook that's going to improve it.

The CHAIRMAN. In the Banking Committee each day, we try to summarize the topical news items of the day that relate to the principal activities of the committee. I don't know how much time any of you have had to scan the morning newspapers today coming on in and getting ready to testify, so, what I'm going to make a passing reference to here may be something that you've had a chance to see out of today's news, or you may not have.

On the front of the Wall Street Journal today, there is a piece called "State of Siege."

The headline is:

"New Hampshire Firms Struggle as Bank Crisis Dries Up Their Credit."

Sub-headline:

"All five of the biggest lenders ailing and businesses can't finance expansion, soaring unemployment rate."

Now, the unemployment rate is up to 6.3. It's come up from 2.2, obviously a radical change.

But, in the article, assuming that it's close to accurate here, you read a number of anecdotal illustrations of businesses, presumably well-run, who can't borrow money, or are having their lines of credit sheared off.

Now, I realize you said earlier, Mr. Weiant, your view is that generally, liquidity and credit are available.

I must tell you I'm hearing from an awful lot of people who are telling me that's not so.

Now, I don't know where the truth lies. And the truth is probably all of the above in terms of who's getting it and who isn't.

But, it's interesting to me that the Wall Street Journal in their news analysis in this piece is of the view that the credit problems in the banks are materially affecting the flow of money to creditworthy borrowers.

That's one item in the news today. Let me just press on with a couple of others. Another is out of the American Banker today.

The headline is:

"FDIC Working to Avert Bank Failures in New Hampshire."

This relates to a meeting yesterday where Bill Seidman met with a summit of Governors from that region of the country and others to try to figure out what can be done in the way of accounting rules, changes in examination procedures, classifications of loans, et cetera, to try to bridge out of the problem rather than to have it just continue to deteriorate on its own.

Let me give you another one here. This one's out of the Investor's Daily today. And the headline on this piece is:

"$100,000 Limit" this of course refers to insured deposits "Unnerved Some Depositors."

It says: "Treasury's reform plan will make it difficult for banks to keep large accounts."

I'll give you just the first paragraph.

"With the Treasury Department's deposit insurance proposals barely 2 weeks old, money already is on the move. One well-capitalized suburban bank was dismayed recently when a 20-year customer moved $300,000 out of his $400,000 out of the bank. The customer reportedly told bank management that he planned to put the $300,000 in Continental Bank, which still is partially owned by the government as a result of a 1984 bailout."

This is a "too big to fail" story and who knows whether it's accurate or not. But it's reported as being accurate.

Here's another piece out of the American Banker today. It says: "No Bank Buying Rush Seen If Barriers Fall."

Now, this is a long, analytical piece that says that the idea of opening up all of these green pastures, in securities where you've got all these casualties as a way to solve the banks' problems doesn't seem to be creating a great burst of investor interest or flow of money.

I won't go on all morning long with this, but just a couple more here. The American Banker has a piece today: "Earnings Round-Up." It says:

"Midwest Banks, Still Strong, Begin to Show Realty Woes."

It runs down through a number of banks that are beginning to see a real estate problem rolling on into the Middle West. And, of course, if your view is right, Ms. Berger, there's a lag to this and so what you see today is just act one or act two of a three or four-act play, and you're going to get more coming down the line later in the year.

Here's another one today also from the American Banker. It says:

"Stock Market Sliced $38 Billion from the Value of the 100 Big Banks in the United States Last Year."

Now, there's obviously been some change so far this year. Some come back in some stocks. But, this is just talking about how the equity markets have revalued banks down and, in effect, have subtracted that amount of equity value.

And it goes on in this vein. I guess what we're left with is, it seems to me, there are so many things at work here, that the job of taking and recrafting the system and moving it in thoughtful steps to a more solid footing is obviously very much needed.

We're getting a lot of flashing red lights all over the control panel, if you will.

I'd like to hear your thoughts as we finish here on how we deal with that mixture of issues which you've been touching on all morning long, and consider that in the context of the global economy on the one hand, you've got hometown bank in Sioux City, IA or Kalamazoo, MI or some other place of one scale, and then you've got Citicorp, who is our global player.

You hear people say:

"Well, look, the only way the United States is really going to make it in the next century is that we've got to have a lot of players that can really get into the ball game with the Japanese and the Germans and the others, and be in this international banking business on an entirely different footing than we presently are.

And, if we don't, then we incur some long-term impairment to our national interest in a global economy.

COMPETING INTERNATIONALLY

I must say, as I each day deal with the compendium of news and facts in the industry, and I try to imagine how we disengage from that and get up to the point where we're winning the gold medals again in international banking with the Japanese and the Germans and others—that seems like it's quite far out on the horizon.

Should that be our goal? Is that the goal we should be setting for ourselves?

How do we move American banking, if we can, into this new global arena?

Is it feasible to imagine that, say, over a decade that we could have five banks in the top 15 globally?

Should that be a goal for the United States?

Is that a practical aim to set for ourselves?

Is it something that we must do in our long-term strategic global interests?

Let me start with you, Ms. Berger. What's your thought?

Ms. BERGER. I'm not sure that's the aim.

I don't think your aim should be to set out to create global powers. Your aim should be to create institutions, or help foster institutions that can compete because they are cost-efficient.

Of all of the Treasury proposals, the one that appeals to me the most continues to be interstate branching. Anything that helps banks rationalize their business and lower their costs will foster a healthier banking system.

Their ability to improve their returns on assets or equity through productivity will help. They need those kinds of returns on equity to help bolster their capital accounts.

I agree with Bill. You don't back off on capital requirements.

The CHAIRMAN. Let me just stop you there, and I won't delay you but for a minute because I want to hear from your colleagues as well, but, the advantage that you attribute to the Japanese is their lower cost of funds, that has been driven by a high savings rate. We have a low savings rate.

Doesn't it tend to follow that, unless we can get our savings rate up to some kind of an equivalent level, we shouldn't fool ourselves about our ability to compete with the Japanese globally when they have that kind of entrenched advantage in their cost of funds?

Ms. BERGER. Yes. But, it shouldn't be your goal to create large, multinational enterprises to compete with the Japanese. If you create a system that's healthy it will probably create the kind of system where you will set up the kind of macroeconomics that you're suggesting that gives them that kind of advantage.

I think it's just a backdoor to the same environment.

The CHAIRMAN. Mr. Weiant, what's your view?

Mr. WEIANT. I agree with what Carole said. Again, I think this is focusing too much on the needs of the money center banks who have been global players and listening to their concerns that we have to have strong international banks, in part, I guess to help them.

The fact is that international banking is not a very attractive marketplace. If you look at foreign banks in the United States in recent years, they are actually retrenching.

I was with a banker for lunch the other day who had closed three out of five loan production offices in the United States. Foreign banks are having trouble making money in the United States. United States banks have trouble making money overseas in the international markets. It's just the basic economics.

If we're worried about the ability to finance some of the U.S. companies overseas because it has sort of macroeconomic concerns, or it's good for the strategic purposes of the United States, then I would suggest that maybe this should be done through a consortium of banks, or be done through an agency of the U.S. Government.

But we should not have a policy in which we look at our domestic banking system to create a strong international bank.

A final point is that, as we go through this change and we have more interstate banking in the United States, we will have the emergency of some very, very large banks—$100–$200 billion in asset size—who will be profitable, who will be core-funded, who will be in a position to handle the international banking needs of the customers.

And the problem is, for a lot of the New York banks, they don't have that core funding. They don't have that logical business base.

The CHAIRMAN. Even though they're out there? They're the ones that have gotten positioned in the international marketplace for the most part.

Mr. WEIANT. Right.

The CHAIRMAN. But it may be that their difficulties are, in part, the fact that they're off a structure that can't really support that very well.

Mr. WEIANT. That's correct.

The CHAIRMAN. Especially in the intensely competitive international banking business that you've just described.

Mr. WEIANT. If you're bidding up for money in the money markets, it doesn't leave you very much spread and, obviously, it doesn't leave you very much margin of error if there are any credit problems.

So, especially if we're going to have strong capital ratios within the banking system, international banking is not an attractive business, again, worldwide, and that's why most people are retrenching.

The CHAIRMAN. You realize, by the way, that part of the war cry in behalf of the proposal that's been made recently by the Treasury Department is precisely along these lines?

It's the Olympic competition argument. If banks from other countries are getting the golds and the silvers and the bronze medals and there's no American bank up in the top 10 or the top 20, that is a mark of a failing nation.

I guess what I'm hearing you say is that really doesn't make a lot of sense to you as an investment banker yourself and that we ought not to chase that illusion.

Is that a fair interpretation of your view?

Mr. WEIANT. The requirement on the asset size is not the determining factor. I mean, profitability is going to be more important, and things like that, in going forth.

Again, you have to look. United States banks are having trouble, large United States banks are. A lot of banks around the world are having difficulty. If you look at Australia, those banks' earnings are way down. If you look at the United Kingdom, even in Switzerland, places like that, there's certain things that are happening in the world right now which are having a pervasive effect on banks everywhere.

CONSORTIUM OF UNITED STATES BANKS

The CHAIRMAN. I like your idea of a consortium of United States banks that would work together to help meet some of the international banking needs of American companies.

Now, presumably, you can meet some of those needs here in the United States if they originate here to the extent that they're associated with activities overseas where you actually need a banking affiliate that is overseas.

Mr. WEIANT. Well, you see, as I say, a lot of the United States banks are retrenching internationally because they can't operate with low enough costs. So they're getting out of most of the—a lot of the European countries. It's just the cost of operation.

Plus, the thin spread doesn't make it profitable. So, again, if some of this lending is in the, quote, "national interest" to make us more competitive as globally, it could be that that consortium would have different capital ratios, or it might even have an investment of the U.S. Government, the Treasury, in that to make it.

The CHAIRMAN. I'm interested. And I think we're going to take a look at that idea.

Yes, Mr. Grant.

Mr. GRANT. Three quick thoughts.

One, in our office, we ran some numbers. We asked ourselves: Is banking a good business? Or, could it be? And we imagine ourselves to be IBM with excess capital. And here banks are going out of business. And is this perhaps an appealing time to become a bank?

There was no way we could make the numbers we ran competitive. IBM should not become a bank.

Now, the next question is:

Should there be regulatory changes that would make such a choice appealing?

And my sense is no because of the legacy of the 1980's. In the 1980's, every single financial activity ballooned exponentially. And great amounts of overhead were built, whether it was mortgage trading, whether it was real estate investment. Whatever the financial related activity was, it attracted enormous investment—acres of floor space, squadrons of bright people. And I think that's over. And if that is over not just for banking, but for investment banking and for mortgage banking, then that implies lean times ahead in financial activity. Nothing says we have to have the financial bubble that we had in the 1980's be perpetuated.

And if what we're looking at is a normal, cyclical reaction against extreme seen in this boom, then we could be looking at years of very sparse returns for financial businesses, in which case, it would be a great time not to be a banker, notwithstanding the new regulatory freedom that the Treasury and the Congress is now weighing.

A final point has to do with this very, very difficult problem of negotiating the shoals of safety.

I am mindful of the great perils we now face and the great irony, right now, that we are the mirror image of the people who are sitting here in the early 1930's, setting up the Deposit Insurance Fund. They had nothing to lose by insuring the system, which was, in fact, purged. And we have everything to lose by giving the appearance of the precipitous withdrawal of these props upon which so much bad debt was created. And it makes one glad not to be a Senator.

I just don't know how you go about dealing with the consequences of what was an unprecedented ballooning of illiquid debt and how we get from here to there. I think I know that to announce summarily the abolition of deposit insurance would be as hopeless, in retrospect as the 1980 $100,000 ceiling was. I mean, you just can't do that, nor do I begin to propose it.

But I think that what we must do is face the fact that somehow we have to get from here, which is a rankly socialized risk/reward structure to one in which there is room to be safe and to be paid for being safe.

The CHAIRMAN. It's interesting. We, in effect, faced a form of that issue in the savings and loan crisis, in which every single abuse that we can find or something we think helped create this problem we're stopping. Period.

It's quite a Draconian way to do it. You go in and you stop all of that, make sure there are no special deals, and so forth.

So, that was done. But, we were left with, the question: did we have a business charter at the other end of FIRREA that was going to be a sustainable business charter, albeit with the new conscriptions?

And the answer is:

Yes for some, and no for others. And this is at a time when financial companies aren't attracting investment capital anyway, as we're seeing, and as you've just said.

So, the more subtle question of what constitutes a viable business charter that lets a surviving savings and loan be capital-attractive, profitable, able to accumulate retained earnings over a period of time within, you know, very tightly defined boundaries—that's a very difficult question in and of itself.

In a sense, it's sort of analogous to part of the question that we're now attempting to answer in the banking area:

What constitutes the scope of activities that ought to go forward? Particularly if you're going to keep federal deposit insurance in place, as we have done in the savings and loan industry.

It leads me to something that you said, Ms. Berger, earlier. When we look at this kind of blowout of money that has migrated over into commercial real estate lending over the decade of the 1980's, should we envision limits, 5 percent of assets or some corre-

sponding amount, on what can be put into commercial real estate because of its volatility in light of the recent history? Should we say for the future that area can't balloon up in a given company's balance sheet to 25 or 35 or 40 percent?

ASSET ALLOCATION

Ms. BERGER. And this goes back to what Bill said earlier. No, that would be asset allocation on the part of Congress.

The CHAIRMAN. Well, no, it wouldn't be. You could call it that. But, you could also say:

Look, these are the areas in which operation can occur. And it can be up to a percentage of assets. It doesn't mean you have to invest any money in that area.

In a sense, it's more a prohibition on asset allocation than it is asset allocation.

You can also say:

You can't get into the used car business, or, you can't get into something else.

There are a lot of things that we say that banks can't do now.

Ms. BERGER. But there will be periods of time where one asset class will grow more quickly than another. You don't want to be in the business of saying "We're not going to allow that area of our economy to grow, if it needs to grow."

And that's what you do when you start saying you can't have more than X-percent in real estate, or in consumer loans. It is the job of the manager of a financial institution to manage that risk within the context of legal barriers.

I think that it goes back to the question that some of the barriers need to come down. These banks did a bad job of rationalizing their business because some of them had little or no choice.

The CHAIRMAN. Well, they did have a choice. They didn't have to invest in the real estate loans. They chose to go that way.

Not all banks did that. A lot of banks didn't do that. Nobody put a gun to their head. The point is, if that's created a huge bubble of risk and it's going to take us years to work it out, why would we want to live in the future with the notion that we'll take our chances again; just recapitalize the insurance fund and, hope it doesn't happen again?

Ms. BERGER. It's still asset allocation. And real estate is not the only asset class that's having credit problems now.

The CHAIRMAN. No.

Ms. BERGER. It's the largest. It's the most visible.

The CHAIRMAN. Right.

Ms. BERGER. It gets into the fact that bankers do tend to act in a herd instinct. Whatever the hot product is, everybody wants to lend on it. And they rationalize it.

When it was Latin American countries and the countries didn't go broke and those countries were growing at 6 percent a year, it became a fad product.

The problem with any of those is:

At what point does Congress want to step in and say, OK, you've lent enough to Latin America? Or, real estate? Or, to the consumer for that matter?

There are very successful financial institutions that have single line products. You can operate as a mortgage banker and be successful. You could operate as a consumer bank, a consumer finance company, and be very successful and live through credit cycles—if you understand credit and the pricing of that credit.

Do you know why J.P. Morgan did not make any real estate loans?

Morgan perceived that there was risk that they couldn't price for and they didn't make any real estate loans.

But, it is not something that I think should be dictated by Congress.

The CHAIRMAN. Here's one of the problems though. I'm sympathetic to the point that you raise. When you get these herd instincts going, nobody's able to make a very good assessment. Maybe a given bank, maybe Morgan takes a look at it and says we're not interested in that, so they look great in the end because they didn't go down the bad path.

But, does everybody else necessarily have a very good capacity to measure how much things are being unhinged from reality because of what everybody else is doing?

In other words, I don't know that when you're running your own institution and you see things on the margin, that you're able to take and cross-relate that to what 500 other institutions are doing.

Now, maybe, in a perfect world, that's what ought to happen. But, obviously, it didn't happen very well in the real estate area because you've got an awful lot of bankers with a lot of egg on their face because they've got a lot of real estate right now that isn't performing.

An awful lot of well-paid, smart people made a lot of big, big-time mistakes. And here sits the taxpayers behind us saying:

"Well, wait a minute. Why are we on the hook for that?" Or, "Why are we likely to be on the hook for that when GAO comes in here and tells us that the Bank Insurance Fund's going to be broke before the end of the year, and not a dime left in it?"

Reischauer of CBO sat right here in this chair a month ago and told us that that's their best estimate. Well, you know, I think the public has a right and we, speaking for them, have an obligation to say: "Why are we back in this fix again? And why should we allow a system to run on that basis that could build up a bubble on a set of mistaken judgments that is going to come back and maybe saddle the taxpayers with $20–$50 billion?"

I don't know what the outside limits might be. It depends, as you pointed out, on how severe the economic problem is we're facing here. That's certainly not outside the range of possibility.

We're talking right now at a minimum with the banks being asked to cough up $10 billion to shore up the insurance fund. And we've had estimates that are far higher than that.

So I guess what I'm saying is, unless we're going to disconnect federal deposit insurance and the liability of the taxpayer from this, as long as the taxpayer is on the line—and we're into a period where the taxpayer is being asked to write some huge checks—that you probably have to reach forward and say:

Look, this is in-bounds; this is out-of-bounds. You can do so much of this. You can't do more than that, of this particular kind of an activity because the risk profile in terms of our contemporary experience is, that we can get nailed.

Now, if the regulators were smart enough, or if anybody else was smart enough—you maybe see these problems when they're building up because maybe they do move from asset category to asset category. It's LDC loans in one time period, and it's an excess of real estate lending in another time period.

But, as long as the public money is put at risk here, then I think you've got to have some ground rules that are more confining. I think they have to be more confining—especially when you've just presented the public with a $500 billion bill.

Because in a bank, we just found that we weren't able to safeguard it very well when there were Federal deposit guarantees in place.

Ms. BERGER. But, it's——

The CHAIRMAN. Yes, go ahead.

ECONOMIC SYSTEM LADEN WITH DEBT

Ms. BERGER. It's not just the banking system. I think therein lies the crux of the issue. It's the system, the economic system, that's laden with debt. And it's not just real estate.

Consumers have far more debt relative to their income than they have had any time in the last 50 years. And the same is true of corporate balance sheets, whether you call them highly levered transactions or just plain, old C&I loans.

That's the facts. And it's not just real estate. Real estate tends to be valued relative to the cash flow that comes off the project. You can mark that to market today. You can't do that for a commercial/industrial loan, or a consumer portfolio.

How can you say we should limit real estate loans when every sector of the economy is also heavily burdened with debt than ever before?

That's the problem. And when we have to figure out how to rationalize that debt had to make the liquidation of that debt balloon less burdensome than it was in the thirties.

The CHAIRMAN. I agree with that. But we're being asked now to look ahead. We're being asked to redo the system, re-engineer it, rebuild it, so that 10 years from now, 12 years from now, 15 years from now, we're not going to be back in a fix like we appear to be in right now.

It would be nice to try to apply as much wisdom as we can in the design so that at least the problems that we are now facing, we try to find a way to avoid the next time around.

I don't think that's an unreasonable approach to take. And I think, if you asked people to react as to whether or not they want the system to be reined in and they're the ones standing behind it to eat the losses if it doesn't work 10 or 12 years from now, I think they'd say: Err on the side of being careful.

Ms. BERGER. Oh——

The CHAIRMAN. About 90/10.

Ms. BERGER. I'm not saying I don't want a safer system. I'm saying that I don't think Congress should be in the business of allo-

cating credit. I think shoring up the regulatory supervision and really flustering a much more efficient banking system——

The CHAIRMAN. Well, let me ask you this.

Should we take commercial real estate loans out of the banking charter? Why can't that be done by somebody else? Insurance companies do it. There are other ways.

Ms. BERGER. Insurance companies are going to have similar problems.

The CHAIRMAN. No, but you don't have insured deposits on the line. I mean, right now, I'm concerned about what I'm going to put that deposit guarantee underneath.

Mr. GRANT. For the sake of the record, commercial real estate was, in fact, an illegal asset class for much of the history of the National Banking Act. It was verboten from 1863 until 1914, and then semiverboten for a long time after that. In 1963 or something, the OCC in annual report said: "Unnecessarily conservative." That was just after they passed the tax law creating the REITS.

So, it's not as if we would now be allocating assets. The National Banking Act allocated assets. It was quite unyielding on this matter of commercial real estate. It was the ultimate heresy. The banker is supposed to know the difference between a bill and a mortgage. That was that.

That was before deposit insurance, which this doesn't make precedent good or bad, but it does make it precedent. We shouldn't act in the dark on this:

Commercial real estate was out. It was simply not admissible as an asset class for a long time. And the fact that it is——

The CHAIRMAN. Excuse me.

Mr. GRANT. I'm sorry.

The CHAIRMAN. No, no, you finish.

Mr. GRANT. Well, the fact that it has been embraced, the fact that it is not only admitted but was elevated, as Carole pointed out in that startling statistic—was the asset of exuberant choice for the last half of the 1980's—my God, it just shows you I think how far you can stray from what passed for traditional banking—one shoe socialized risk, and one shoe throw out the rules of liquidity, which now the Chairman of the Federal Reserve Board has blessed.

The CHAIRMAN. The problem that I think you start to have is that, to an individual bank it may look like it's a wonderful way to go and there's really not a good way to add it up industry-wide to realize that maybe this isn't so great because 500 other people are doing it, and that's going to impair the value that's down the line in this situation.

And the regulators can be well-intentioned, but they're not going to be able to do it either.

So, what I feel driven back to as a Senator is to, in the architecture, somehow in the engineering design, in terms of what's inbounds and what's out-of-bounds and how much of one thing you can do versus another, you have to build in a certain set of safety measures and counterbalancing forces as wisely as you can.

Now, if you don't have Federal Deposit Insurance, then it's a different story because then anybody that wants to can go out and collect some capital and go into a business and risk the capital any way they want, and earn or lose the money, what-have-you.

But, when you're going to have Federal Deposit Insurance guarantees there, I think you have to have some bona fide public purposes that are being served, number one. I think you've got to have a very clear set of public values and gains that are being gotten here.

When you're going to base it all on Federal Deposit Insurance, I think a set of questions has to be applied as to whether or not it's safe, it's sound, it serves some broad national purpose.

I don't think it can just be to grow the size of a bank. I don't think a bank is entitled to grow 15 percent a year, or 20 or 30 or 50 percent a year by fiat. And maybe, some years, banks don't grow. Maybe, some years, banks actually recede in size. I mean, maybe that's part of the nature of what has to go at least with respect to what I would think of as kind of a core bank that rests on Federal Deposit Insurance.

Now, that's awfully confining as a concept. And I can see why somebody might say:

Well, if that's the best you're going to do for me, I'm out of banking. I'm going into investment banking, I'm going to go into something else. I'm going to go into something that's got a different profile and where I can really have a growth rate that will make me a superstar.

I think that's part of the quandary here that we're stuck with, and we need some help. I don't think it's enough to say after the fact:

Look, you know, we went on a real estate binge and now the system's in jeopardy, and we're going to try to work our way out of it. But that doesn't mean that we shouldn't in the future think of some kind of a way to box off those levels of risk so that we don't create those bubbles in a financial system where you've got Federal Deposit Insurance.

Mr. GRANT. You know what the trouble is with that though? If we knew where the risk would be to start with, we'd never move because knowing where risk would be, we would be short or long in the appropriate security.

I mean, if I were a banker——

The CHAIRMAN. You don't have Federal deposit guarantees under the stock market.

Mr. GRANT. Right. But, if I were a banker and knew that investment banking was a place to be, I might just invest in Merrill-Lynch. In other words, I think to know exactly what the future is going to hold so far as risk and reward is, is a very difficult thing to know.

The CHAIRMAN. No, no, you can't know that, but you ought to be able to draw some lessons out of your history. Otherwise, history doesn't mean a thing. And you can just keep knocking your head into the same wall time and again.

I've got to tell you that I'm worried about the risks I see right now. I think the system is in greater jeopardy right now than it should be in. There are a whole lot of reasons why that is so, but I think it's profoundly in our interest to get out of the high-risk position that we're in—I'm talking about just the systemic risk to the economic and financial system.

There's a reason why all these news articles are being written each day. These problems are real and they're threatening. That doesn't mean they can't be managed, but I think we've got to draw some lessons out of here so that, in the redesign, at least for the part where you've got federal deposit insurance in place, that you've got a better way of understanding and circumscribing and capturing your risk profile.

Now, that's going to cause some heartburn because, in effect, it may mean you narrow it down. It may mean you only broaden it a little. It's a tough set of tradeoffs.

But, I don't think you can sign the public up to underwrite the risk unless you're very confident about the risk profiles you're taking on and pretty darned restrictive about it.

And people aren't going to like that.

I remember one time Walter Wriston was in here and he made a great argument for freeing banking up and going in all different kinds of directions. I asked him if he was prepared to give up deposit insurance.

There was sort of a long pause and, he decided he'd just as soon keep deposit insurance. He really wasn't quite ready to give up deposit insurance, although he made it sound as if we were doing him a favor by giving him deposit insurance. It's not something that he particularly wanted to ask for, but he was very clear he didn't want to give it up.

And I think we're at a point now where there's no more free lunch. And there's no more free deposit insurance. What goes on top of deposit insurance, in legislation that I'm going to have any part in signing my name to, is going to have to be something that I have some confidence is not going to blow sky-high somewhere down the road 10 or 15 years.

There are no guarantees and we may get it wrong, but I want to apply a very tough standard to the question of what we're signing the public up to, to have to underwrite.

Listen, thank you for being here and for talking with us and for giving us your views.

They're very helpful to us.

Ms. BERGER. Thank you.

Mr. GRANT. Thank you.

Mr. WEIANT. Yes, thank you.

The CHAIRMAN. The committee stands in recess.

[Whereupon, at 12:40 p.m., the committee adjourned.]

[Response to written questions follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

Carole S. Berger
Managing Director
C.J. Lawrence Inc.

Response to Questions for the Record
Senate Banking Committee
Hearing on the Condition
of the Banking Industry
February 21, 1991

1. Recently, bank securities prices have reversed part of last year's sharp declines. Is that just a correction, or have bank prospects improved, and if so, why?

Bank securities rallied materially after the Fed reduced the discount rate for the second time in February, as did the rest of the stock market. Investors took that as a signal that the Fed would not allow the economy to fall into a deep and/or prolonged recession. As far as bank equities are concerned, such price action is classic. In each of the last six economic cycles, bank equities have bottomed when the Fed began injecting liquidity to the economic system, thereby stimulating economic activity.

The rebound in bank stock prices comes partly from the fact that prices probably overcompensated on the downside when investor fears regarding loan losses were unjustifiably negative. The other reason for the sharp rebound was purely valuation-related. Specifically, a broad index of bank equities had a dividend yield of 8% (compared with the yield for the S&P 400 of 3%). As the discount rate was reduced from 7% to 6% over a very short period of time, bank dividend yields looked very attractive to investors.

If Fed easing does result in a resurgence of economic growth, then there is reason to be more sanguine about the prospects for the banking industry. Traditionally, after the economy rebounds from recession, credit quality slowly improves. However, as the full text of my testimony outlined, credit-quality improvements will lag the economy. As a matter of fact, even if we are witnessing the weakest economic activity now, credit-quality measures will likely continue to rise for the full year. In addition, I have enclosed my latest research report for the record. Dated March 8, 1991, it is titled "Bank Stock Investing - - What's Next?" This report describes the classic recovery cycle as is pertains to credit quality, as well as the implications for bank stock performance.

2. The Fed has lowered its interest rate targets 2 percentage points since last summer, but most banks have lowered their prime rate only half as much. Why has the prime been held up?

While interest rates have declined dramatically over the last year, I do not believe that it was due to Fed policy. As a bank analyst, it appears to me that there has been a drop in the demand for credit. The reduced demand has resulted in lower prices for that credit, particularly at the short end of the yield curve. If the Fed were easing, reserves in

the banking system would be rising. Just the opposite is true. Reserves have been stable for the last four years. The Fed has not injected liquidity. Without new reserves, liquidity of the economic system is being squeezed. That has resulted in a widening in the spreads between the best-quality credits and those of lesser quality. The prime has not declined as much as Fed funds because of the quality differentials between those two types of assets. A more dramatic example of this phenomenon would be junk-bond yields; they have actually risen in the last 12 months.

3. Do you think the industry's large loan losses and high failure rate are temporary problems that will end after a year or two, or are they likely to continue over a longer period?

Yes and yes. Large loan losses and high failure rates are likely to be cyclical. However, the underlying, longer-term trend of loan losses and failures is probably rising. Furthermore, given the very high debt levels in the U.S. economy today, the amplitude and longevity of any cyclical move will be much more pronounced.

As it pertains to this cycle, I do not think that we have yet reached the peak in problem credits. I believe that in an improving economy, peak levels will be reached late this year or early next year (see my original testimony for a more detailed analysis).

4. Comptroller General Bowsher of the GAO wrote to me earlier this month regarding his concerns about the BIF and added, "we have evidence that the banks lack effective controls over their operations and that accounting is masking their true condition." Do you share his concerns?

Not uniformly. The growth in financial assets over the decade of the 1980s was extraordinary. Any prudent manager has to be concerned that the systems to monitor that growth may not have developed as quickly. There are a few large banks that do not seem to have the management information systems to control credit and interest rate risk adequately. In general, however, I do not feel that this is an industry problem. I would encourage better regulatory oversight in this area.

I do not agree with his view that accounting standards are masking the true condition of these banks. Analysts will always prefer more information to less. However, over a long period of time, I've found that banks which make huge lending errors do so by betting on one economic factor. For instance, in the inflationary era of the 1960s and 1970s, banks which lent on the collateral value of any commodity had much better credit quality than their peers. This became the credo of the 1980s: Lend on asset values. Inflation will bail you out if your underwriting standards are lax. So banks lent to Latin America (basically commodity-based economies). They made energy loans, and last but not least, they lent on the appraised value of real estate. Accounting standards had nothing to do with these lending policies. It was the deflation of the underlying collateral which exposed inadequate underwriting standards.

5a. The new regulatory guidelines issued March 1 encouraged greater disclosure of information regarding nonperforming loans. How helpful do you think you would find such information?

Very helpful. Broader disclosure on the state of nonperforming real estate loans may aid us in differentiating those banks with temporary problems and those which will record losses significant enough to warrant caution on the part of equity holders, debt holders, and perhaps large depositors.

b. They also prescribe valuing collateral not at liquidation value, but rather using estimates of future rents. Is that a good idea, or does it risk becoming a way of deferring the bad news?

Conceptually, this is a good idea. But I have no idea on how you implement such a concept. I'm pretty sure that if you put ten real estate experts in a room and ask them to value one piece of real estate, you will get ten different values. Estimating future rents correctly requires a crystal ball which accurately predicts local economic growth, absorption rates for real estate under that scenario, and the reaction of developers to those economic developments. Will they build more because they expect a turn in the market? Ultimately, the value of real estate is tied to the cash flows on the property. It is probably wrong to value real estate at it's liquidation value. It is equally problematic to project future rents. If such an approach is developed, it will also be very difficult to apply it uniformly to every market.

Regardless of the merits of each valuation approach, it is very important to allow banks to defer some of their losses on real estate. I would refer you back to the real estate section of my original testimony instead of repeating myself here. In summary, requiring large, rapid write-offs of bank capital can cause a "credit implosion" and have serious negative implications for the economy. Allowing banks to recognize these losses over a longer period of time would reduce the overflow impact to the economy.

6. What will be the effects of higher deposit insurance premiums? How much can the industry afford?

I have not done any statistical studies on the effect of higher premiums nor the outer limit which would create more problems than it solves. But I urge you, once again, to phase out the "too big to fail" doctrine. It is raising the cost of deposits to all banks and nationalizing bank's credit losses. The markets must be given the opportunity to weed out high-risk banks so that the taxpayers do not end up paying for the cleanup later. I said it in my testimony and I repeat it again here: "Too big to fail" is the single largest problem the U.S. banking industry has to deal with today.

If nothing is done and FDIC premiums continue to rise, some of the best U.S. banks will likely seek banking charters abroad and drop their U.S. banking licenses. You are unfairly penalizing the good banks, undermining their profitability, and ultimately weakening the system by perpetuating a system which rewards risk taking and unsound practices.

7. How much could costs be cut by mergers of large banks in the same market area?

The general rule of thumb analysts cite is: Intramarket mergers result in cost savings equivalent to 30%-40% of the expense base of the smaller of the two banks being merged.

8. How helpful would full market value accounting or increased market value disclosures for banks be?

I oppose full market value accounting. It would create unnecessary swings in bank capital which would exacerbate liquidity concerns during periods such as the one we are in now. For instance, when interest rate rise, the value of fixed-rate loans and investments would decline and banks would: (1) not make fixed-rate loans such as home mortgages and (2) have to write off the difference between the market value of the loans and investments at the last reporting period and the current period, putting pressure on their capital structure and possible affecting their ability to make other types of loans. This example is simplistic but generally accurate. A change to mark to market accounting would change the way banks create credit, not necessarily for the better.

As far as disclosure, as I alluded to earlier, no analyst would discourage greater disclosure.

C. J. Lawrence

Number 116

March 8, 1991

BANKING INDUSTRY

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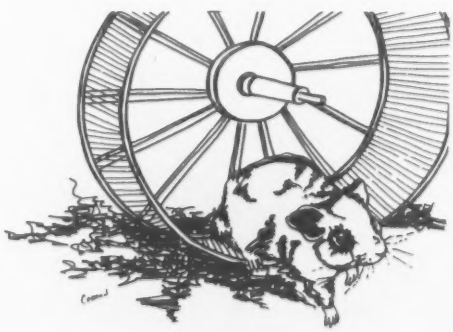
BANK STOCK INVESTING - - WHAT'S NEXT?

- Phase I of the Recovery -- Economy Improves, but Credit Quality Doesn't.
- "Stress-Testing" Bank Earnings Estimates.
- What Are: Trough Earnings, "Sustainable" Dividends, and "Real" Book Value?
- A Structured Valuation Model.
- Lingering Fears - Has the Fed Eased Enough?



Get me off this treadmill. These people want to stress-test everything!

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Investment Summary and Conclusion

As the Fed eases aggressively, investors become willing to look through the trough of the credit cycle. They search out "sustainable dividend", "real" book value, and recovery earnings. Credit quality usually continues to deteriorate (see section on The Classical Recovery) even as the economy picks up. However, investors begin to differentiate between banks with significant enough problems to jeopardize dividends and book values and banks which will survive and/or prosper after the cycle.

We have attempted to create an earnings estimate "stress-test" for each of our banks (the full description is covered in a later section). The purpose is to ferret out companies with sustainable dividends, their year-end 1991 book values, and some estimate of a mild earnings recovery in 1992. We then structured a valuation model around targeted dividend yields and price-to-book value ratios. We applied these targets to estimates of year-end dividends and book values, which were a derivative of our earnings stress-tests. In this way, we try to mirror the investment process during this early stage of the classical recovery. Based on this theoretical approach, we are reaffirming our three purchase recommendations, upgrading five banks from HOLD to BUY, and downgrading one as follows:

Reaffirm Purchase Recommendation	Upgrade to BUY	Downgrade to AVOID
BankAmerica	Mark Twain Bancshares	PNC Financial
First Bank System	Firstar Corporation	
KeyCorp	First Fidelity	
	NBD Bancorp	
	Society Corporation	

There was nothing in our stress-test and valuation methodology that would cause us to upgrade the following banks:

Name	Current Rating
Bank of Boston	SELL
Barnett Banks	SELL
Chase Manhattan	SELL
Citicorp	SELL
Fleet/Norstar Financial	SELL
Manufacturers Hanover	SELL
MNC Financial	SELL
Shawmut National	SELL
Southeast Banking	SELL
Valley National	AVOID

Chutes and Ladders

Last weekend, my two preteen nieces engaged me in a challenging game of Chutes & Ladders (at least that's what we called the boardgame when I was their age). Land on the right spot and you can ascend several levels by climbing a ladder and bypassing the normal, longer route. Land on the wrong square, however, and you suddenly find yourself back at the beginning after sliding down the dreaded chute. Such was my fate, much to the delight of my two small adversaries. I must confess the game felt oddly familiar. Bank analysis and investing these past couple of years has required navigating much the same kind of field, with a few more chutes than ladders.

Figure 1

Source: Company reports and C.J. Lawrence Inc. estimates.

As Figure 1 shows, bank stock prices advanced almost 40% in the first ten months of 1989, only to give it all back during the following six months. By the end of April 1990, both multinationals and regionals were 8% to 10% below where they started 1989. During May of last year, the group posted a respectable rally. When investors refocused on deteriorating fundamentals during the summer, bank stocks began a long steep slide, bottoming in October of last year. After regaining some ground in the fourth quarter, regionals tested their October lows in early February. Multinationals did somewhat better but underperformed the overall market. (A relative price performance chart is shown in Appendix I at the end of this report.) It wasn't until the second discount rate cut that bank stocks took off. Such performance is classical. In our December 4, 1990 report, we noted:

"Typically, bank stocks bottom when the Fed eases (see Table 1). Intuitively, one might have thought that this would occur at the onset of recovery or perhaps soon thereafter.-- However, the evidence suggests this is not the case. When the Fed eases, even during a recession period, bank stocks bottom. We believe that investor concern about the length and depth of the oncoming recession typically abates when the Fed moves aggressively to reliquefy the economy. In turn, as fears of a deep and prolonged recession subside, so do fears of a black hole of loan losses. This creates the psychological shift and provides a bottom for bank stock prices."

Table 1

THE TIMING OF BANK STOCK BOTTOMS, 1960 - 1991

Onset of Economic Slowdown	Fed Easing (a)	Economic Recovery Begins	Bottom in Bank Stock Indices
May 1960	Jun 1960	Feb 1961	Jun-Aug 1960
Jan 1970	May-Jun 1970	Nov 1970	May 1970
Dec 1973	Aug 1974	Mar 1975	Sep 1974
Feb 1980	May 1980	Jul 1980	Mar 1980
Aug 1981	May 1982	Nov 1982	Jul 1982
Sep 1990	Feb 1991	?	Feb 1991

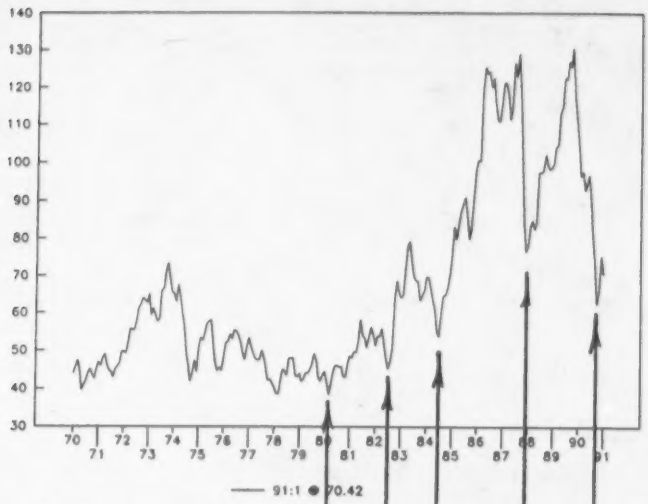
(a) Somewhat arbitrary--either decline in Fed funds, or shift in rate of change in M1 (either year-to-year or six month annualized).

Typically, it is the very attractive dividend yields that bank stocks offer at the end of the cycle which attract investors back to this group. Figure 2 shows the S&P money center banks index along with the corresponding dividend yield. Historically, dividend yields of 8% have marked the bottom in bank stock prices. This cycle was no different. After dividend reductions by Chase Manhattan, Chemical, Citicorp, and Manufacturers Hanover, the S&P money center banks index yielded 8% at year-end 1990.

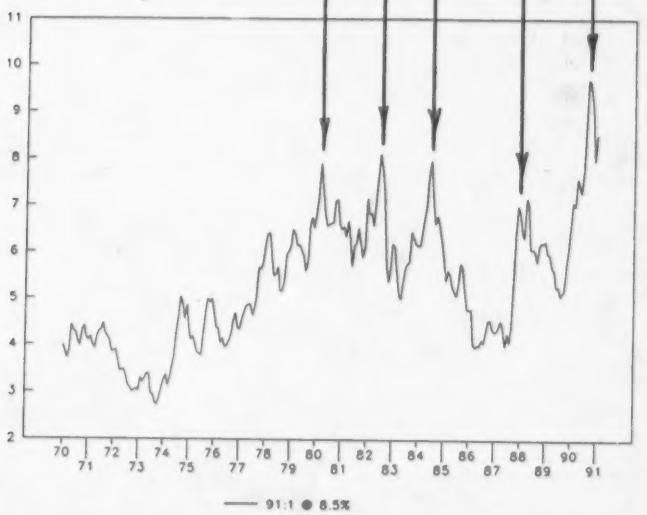
This cycle was different only to the extent that there were far more dividend cuts and eliminations than in any other postwar cycle. Even after numerous dividend reductions, regional banks as a group reached a dividend yield of a little over 8% in October 1990. Multinational banks were yielding 8% at year-end even after Citicorp and Manufacturers Hanover reduced their payouts. When the Fed dropped the discount rate from 7% to 6% in six weeks (between January and February of this year), the combination of shifting psychology relative to economic prospects and high dividend yield provided the valuation bounce for bank stocks.

Figure 2

S&P Money–Center Banks Price Index



S&P Money–Center Banks Dividend Yield



So far, nothing that has transpired is materially different than previous cycles. As the credit cycle unfolded, investors lost the traditional valuation framework for bank stocks. Earnings were suspect, making price/earnings (P/E) analysis irrelevant. Similarly, book values were questioned. This left only dividend yields to provide the valuation floor for bank equities. The numerous dividend cuts made this more difficult. The classical pattern from here would be to slowly regain those valuation parameters as stimulative Fed policy results in economic recovery, which, in turn, brings an end to the credit quality problems. Once again, we believe that history is likely to repeat itself. This time, however, there may be several important wrinkles in the classical recovery of bank equities.

The Classical Recovery

It is likely that the recovery will come in what could be considered two phases. During the first phase, the economy gets better, but credit quality continues to deteriorate. Even if the cycle follows the traditional pattern, it will take several months for Fed easing to turn the economy. Second, credit quality improvements lag the improving economy. Put simply, credit quality is likely to get much worse before it gets better. The second phase, which is unlikely to take shape until 1992 at the earliest, would be marked by declines in both nonperforming asset ratios and net chargeoffs. We believe that it is far too early to invest based on theoretical values created by the second phase of recovery. Rather, the market has not yet fully reflected the impact of phase one. Therefore, we will focus the rest of this discussion on analyzing and investing during the first phase of the recovery.

In the 1974-1975 cycle, the Fed began easing aggressively in August of 1974, but the recovery did not take shape until March of the following year. Loan loss provisions and net chargeoffs rose throughout the period. For the 45 large banks we followed in those years, net chargeoffs and loan loss provisions continued to rise. Net losses as percentage of average loans climbed from 0.22% of loans in 1973, to 0.35% in 1974, and 0.66% in 1975. Loan loss provisions moved in lock-step from 0.26% of average loans in 1973, to 0.49% in 1974, and peaked in 1975 at 0.76%. Even though the economy was on the mend by March 1975, credit quality was materially worse in 1975 than in 1974. Of the 45 banks we followed at the time, net chargeoffs ratios increased at 41 banks in 1975, stayed the same in one, and improved in only three cases. Of the three cases which improved, two were banks with huge problems, which had been running loan losses at two and three times the industry average. Only one bank, First Security Corp. of Utah, posted an honest to goodness improvement in credit quality.

During 1975, however, there was a much greater divergence of loan loss performance. Table 2 shows the distribution of net chargeoffs as a percentage of average loans from 1973 through 1975. While almost all banks showed a deteriorating pattern in 1975, there was far less homogeneity in the severity of those losses.

Table 2

DISTRIBUTION OF LOAN-LOSS
EXPERIENCE AMONG THE 45 BANKS, 1973 - 1975

Net Losses As a % of Average Loans	Number of Banks 1973	1974	1975
0.00 -0.14%	17	3	1
0.15 -0.29	16	18	6
0.30 -0.44	9	15	7
0.45 -0.59	1	5	12
0.60 -0.74		3	2
0.75 -0.89	2		7
0.90 -1.04			2
1.05 -1.19			3
1.20 -1.34			1
1.35 -1.49			3
1.50 -over		1	1
45 bank average of net loan loss as a % of average loans	0.22%	0.35%	0.66%
Standard deviation	0.17%	0.23%	0.37%

Source: Banking Industry Development, June/July 1976, Goldman Sachs Investment Research

Geography played an important role in the past two credit cycles. In the 1974-1975 cycle, southeastern banks were hard-hit with real estate problems, and northeastern banks suffered from problems in textiles, shipping, and other commercial loans. During 1981-1982 cycle, the southwestern banks were decimated first by energy and then by real estate loan problems.

Going back to our observations regarding the 1974-1975 cycle. There were major differences in the earnings pattern created by the divergence in credit quality and geographical differences. Table 3 shows the year-to-year earnings per share growth patterns of banks in several regions going into and coming out of the 1974-1975 recession.

Table 3

EARNINGS PER SHARE GROWTH, 1972-1977

	1972	1973	1974	1975	1976	1977
Multinational banks	5.8%	13.9%	14.6%	1.9%	-2.2%	9.5%
Northeastern	5.8	7.3	-7.5	-2.0	4.7	10.2
Southeastern	17.6	13.0	-14.7	-16.3	1.5	19.4
Texas	7.6	20.7	20.9	8.4	7.5	17.3
California	7.0	9.9	9.5	11.7	12.2	24.7
Mid-central	7.0	12.5	8.5	8.9	3.5	12.9

Source: Banking Industry Development, June/July 1978, Goldman Sachs Investment Research

The southeastern banks fared far worse than any other region in the 1974-1975 recession. In 1974, earnings declined an average of 14.7% and the rate of deterioration increased in 1975, when earnings declined another 16.3%. Also of note was the slow rate of earnings recovery in 1976. These banks posted only a 1.5% increase in earnings in 1976 from what had to be considered a very low base. The impact of the economic recovery was not felt until 1977 when earnings rebounded 19.4%. Interestingly, that same year California banks posted gains of 24.7%, even though they had never had an earnings slowdown during the recession.

Again we believe that history will repeat itself. The areas of the country that were the first to experience recessionary forces will be the areas which recover last and vice versa. LIFO, last in/first out, is likely to be operative. Almost by definition, the last area of the country to exhibit weakness will be the closest to the period of Fed easing. More specifically, the Midwest and California are unlikely to ever get as bad as New England, the mid-Atlantic region, or the Southeast.

We believe there will be strong parallels to the 1974-1975 cycle as a recovery develops. Specifically, it is reasonable to assume that:

- o Credit quality will deteriorate sharply this year -- nonperforming asset ratios and net chargeoffs should rise for all banks.
- o There will be a greater divergence of credit quality measures. Already weakened banks, especially those with overexposure to real estate, will continue to show the greatest deterioration.
- o Geography will continue to influence the cycle. New England banks will suffer far more than any other region. Mid-Atlantic and Southeastern banks will continue to weaken. Midwestern and West Coast banks will deteriorate but will likely show the least effects of any downturn.
- o Loan loss provisions will keep pace with increases of net chargeoffs. Reserve coverage to nonperformers will likely fall but the dollar value of reserves will not be allowed to decline in the face of rising nonperformers.

We also believe that due to the extremely high level of debt in the economic system, there are likely to be several important wrinkles in the classical recovery.

The Wrinkles

The debt boom of the 1980s has left the economy as highly levered as anytime since the 1930s.

Figure 3

DEBT AS A % OF GNP

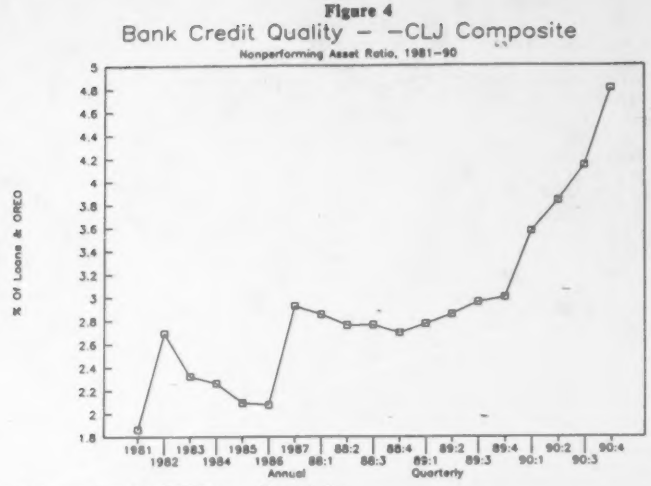
Source: U.S. Bureau of Economic Analysis.

We believe it is the back side of that ballooning debt that we are now dealing with. All segments of the economy have been leveraged: real estate, corporate America, and the individual. It is likely we are entering a debt liquidation phase. Such liquidation will present two wrinkles to the classical recovery. It will likely result in:

- The worst credit cycle of the last 50 years; and
- Little or no loan growth during the recovery phase.

Without a doubt this is the worst credit cycle since the Great Depression. Figure 4 shows nonperforming asset ratios over the last decade for the 41 banks we follow closely. (In addition, the data also includes nonperformers of Bank of New England for continuity of the series.)

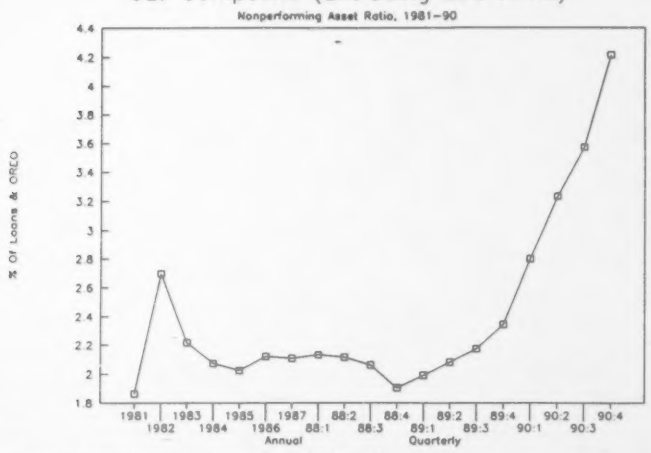
Figure 4



Source: Company reports and C.J. Lawrence Inc. estimates.

After an interim peak at the end of the 1981-1982 recession, nonperformers declined in 1983 through 1986. With the onset of protracted payment problems of LDC credit, nonperformers jumped in 1987. Without LDC credits (see Figure 5), nonperformers continued their downward trend, troughing at year-end 1988. Over the last two years credit quality has deteriorated rapidly.

Figure 5



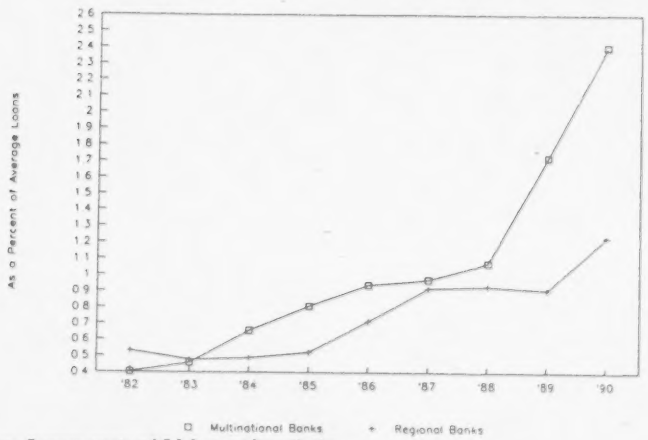
Source: Company reports and C.J. Lawrence Inc. estimates.

Nonperforming asset ratios for these 41 banks rose from 3.0% at year-end 1989 to finish last year at 4.8%. This level is almost double the peak of the 1981-1982 recession of 2.7% for these banks. Comparable data is not available for the 1974-1975 recession, but we suspect nonperformers were slightly lower than the 1981-1982 cycle.

Net chargeoffs patterns are somewhat more telling. Net chargeoffs have never really declined since the 1981-1982 recession (see Figure 6). Many banks are at such high levels of nonperformers and net chargeoffs that further erosion of credit quality may necessitate further dividend cuts and/or eliminations. Several institutions are barely breaking even, and are likely to have to start downsizing in order to maintain capital ratios if they begin reporting operating losses. Moreover, a few banks have such high levels of problem assets that any further serious erosion might jeopardize their existence. It is likely that we may witness several large (among the 50 largest) bank failures this cycle.

Figure 6

Net Chargeoff Ratios, 1982–90



Source: Company reports and C.J. Lawrence Inc. estimates.

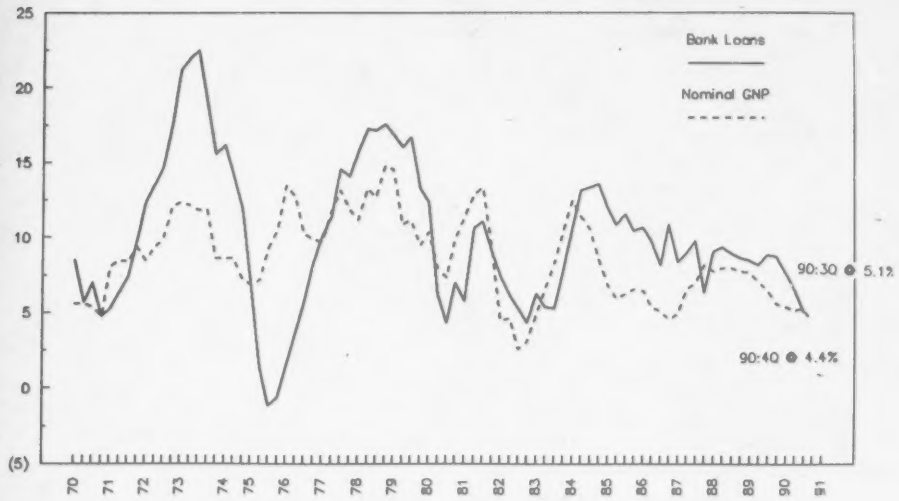
If any one of these problems is large enough or is considered a huge surprise, it may affect the valuations of bank equities during the early recovery phase. Such problems did not influence the previous cycles. By the time the large Texas banks failed, the markets had already clearly identified them as problems. They did not come at a time of stress for the industry as a whole and did not affect bank stock valuations.

Another factor that could be very different during this cycle is the prospect for loan growth coming out of this credit cycle. Normally, as the Fed initially eases and the banks are reliquefied with new reserves, banks invest in Treasury securities. After nominal economic activity heats up, loan growth reaccelerates. Figure 7 shows the historical relationship between nominal GNP growth and loan growth. Normally, loan growth does not start to reaccelerate for 6 to 12 months after nominal GNP bottoms.

Figure 7

BANK LOANS vs. NOMINAL GNP

Year-to-Year % Change



Source: U.S. Bureau of Economic Analysis and Federal Reserve Board of Governors.

In this cycle, loan growth during the recovery phase is unlikely to be very robust. Real estate loans accounted for 62% of all new bank lending between 1986 and 1990. Non-residential new construction has averaged 44% of total private construction since 1976. Therefore, 25%-30% of all bank lending the last six years was directed to non-residential properties -- office buildings, hotels/motels and retail space. With a 10-year oversupply of office space, as well as overcapacity in retail space and hotel/motels, it is unlikely that real estate loan growth will even approach the 1980 levels. Over the decade of the 1980s, real estate loans grew at almost a 14% average annual rate. We cannot envision an environment which would require such loan growth.

Commercial loan growth averaged only 7.5% annually over the past decade, with the last surge for highly leveraged transactions. The LBO craze was created by gaps between private market values and public market values. With the Dow pushing 3,000, it is unlikely that much of a deal flow will return. Banks will more likely vie for the business of restructuring existing credits if interest rates decline further. Consequently, it is unlikely that corporate loan demand will be vibrant.

Similarly, consumer balance sheets are overleveraged. Consumer debt is now 81% of disposable personal income (DPI), a postwar record. Figure 8 shows this relationship. In the last two recessions this ratio has declined. We believe that in order to make the case for robust consumer loan growth, one has to argue for a meaningful reacceleration of DPI. However, DPI at the moment is falling. Figure 9 shows the relationship between consumer debt growth and growth in disposable personal income. The relationship is fairly good. Rarely has debt grown without income growing. In fact, income growth has historically picked up 6 to 12 months before lending reaccelerated. We, therefore, believe that consumer debt growth will be less than exciting in the next 12 months.

We are in the midst of a debt liquidation phase. The credit cycle is part of that -- the worst credits will result in loan losses. It is also likely that loan growth will continue to slow for the next six months and then bottom. But we would caution that loan growth thereafter is unlikely to be robust.

This will make it even more difficult for banks to grow their way out of this credit cycle. In addition, any earnings rebound in 1992 is likely to be driven by a cessation of credit problems and by expense controls, as opposed to loan growth.

The Stress Test

We have taken what we have observed about asset quality in the first phase of a recovery, as well as our outlook for lackluster loan demand, and adopted a methodology for stress-testing our earnings models. The purpose was to design a framework that would protect us from our own biases. Furthermore, we call it a stress-test because the purpose is to divine "sustainable" dividends and "real" book values. It is such variables that will provide the valuation criteria investors seek before any earnings rebound takes shape.

In general, the framework for stress-test assumes:

- Nonperforming assets rise 67% between year-end 1990 and 1991.
- Reserve coverage ratios fall, but minimums for both multinationals (35% of non-LDC nonperforming loans) and regionals (50% of nonperforming loans) were set.
- Net chargeoffs ratios rise 25% this year for multinationals (again on non-LDC exposure) and 50% for regionals, where exposure to real estate is much greater.
- No material asset sales or gains on investment securities not already transacted.
- Declines in nonperformers, net chargeoffs, and loan loss provisions in 1992.
- Mid-single digit earning asset growth, at best.

Figure 8

CONSUMER DEBT AS A % PERSONAL INCOME

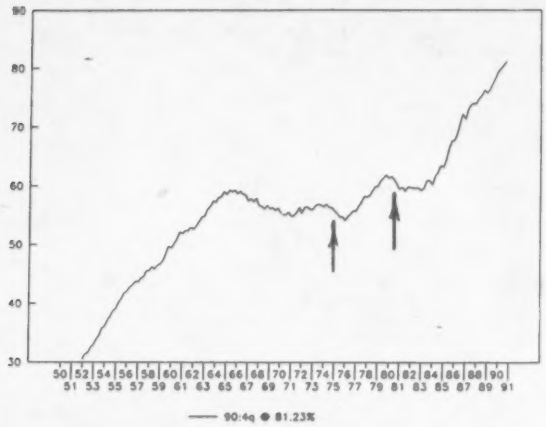
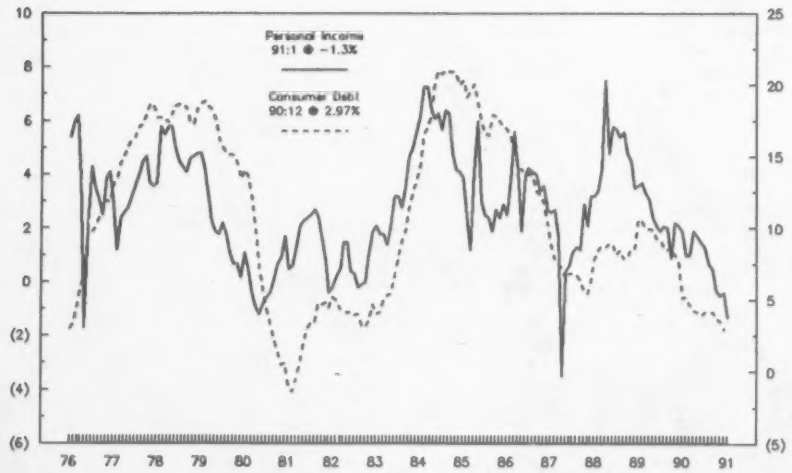


Figure 9

REAL PERSONAL INCOME VS. CONSUMER DEBT

Year-to-Year % Change



Source: U.S. Bureau of Economic Analysis and Federal Reserve Board of Governors.

We are not trying to imply any precision in this methodology. For instance, on a linked quarter basis we have increased non-LDC nonperformers 10% in the first quarter, 20% in the second, 15% in the third, and 10% in the fourth. Behind these assumptions we gave banks some credit for trying to "clean house" by identifying problems in the fourth quarter of last year. Furthermore, we recognize that the most rapid deterioration should come near or slightly behind the weakest part of the economy. By way of reference, non-LDC nonperforming asset ratios at the 41 banks we follow deteriorated 80% last year -- 19.6% in the first quarter, 15.5% in the second, 10.5% in the third, and 18.0% in the final quarter. Even if this quarter's GNP performance is the weakest, it is logical, based on historical precedent, that we are only half way through the credit cycle. Viewed in historical perspective, we do not believe that our assumptions are overly pessimistic. In fact, we strive to make them as realistic as possible without being pollyannaish about the situation.

We understand that regulators are unlikely to be as stringent this year as they were last year, and have reflected this by allowing reserve coverage ratios to fall. However, we set minimums. For multinational banks, reserves as a percentage of non-LDC nonperforming loans were not allowed to fall below 35%. (Except Citicorp, where the ratio of non-LDC reserves to nonperforming assets is below 30% already. Here we allowed coverage to fall to 20% of non-LDC nonperforming assets.)

For regionals, we did not allow the reserve to nonperforming loans to fall below 50%. For some banks, where other real estate owned (OREO) is large this left the total coverage ratios much lower. We felt this was appropriate since banks mark-to-market the real estate when they foreclose on it. Further writedowns are an expense item and not run through the reserve. Therefore, the reserve exists for nonaccrual loans, and total coverage ratios should not be as high for institutions with larger OREO portfolio.

For the regionals, we assumed net chargeoffs ratios increased 50% from last year. This may seem high, but remember, between 1974 and 1975 net chargeoffs ratios rose 88.6%, after a 59.1% increase in 1974. At a half a dozen institutions where chargeoffs were especially high last year due to a management decision to clean house or because terrible credit quality, 1991 chargeoffs were estimated on a trendline basis.

At multinationals, a 50% increase in the non-LDC net chargeoffs ratios would have put half of them out of business. Consequently, we were kind, forecasting only a 25% increase at most. At BankAmerica and J.P. Morgan, net chargeoffs were very low last year at only 0.35% and 0.30% of loans, respectively. In both of these instances, we increased these ratios by 50%. At Bank of Boston, in contrast, net chargeoffs have been running almost 3% of loans during the last three quarters. Nonperforming loans have thereby been held flat in dollar terms. For Bank of Boston, we assumed these trends continue as the New England economy continues to flounder.

In general, as we assumed a cresting of credit problems at year-end 1991, lower nonperformers and loan loss provisions were forecasted for 1992. The percentage decline in loan loss provisions was directly related to the level of nonperformers at their peak.

Structured Valuation Approach

Although credit quality continues to deteriorate, investors will try to look through the credit cycle as the economy recovers. They will not be discouraged by trough earnings, and they will try to look beyond them. Valuation frameworks, which were lost as fundamentals hit the skids in 1989, will slowly rebuild, starting with a reasonable yield on "sustainable" dividends; followed by a more realistic valuation of price-to-book value once investors become convinced that book value is "real" and will not be seriously eroded by operating losses; and ultimately, some price/earnings ratio will be applied to recovering earnings.

Our stress-test provides sufficient information to lead us two-thirds of the way through this rebuilding of valuation parameters. The final parameter, P/E analysis, will not be viable until phase two of the recovery is in place. Phase two will come only when credit quality begins to improve. That event is unlikely to begin until 1992 and is equally as unlikely to pick up steam until 1993. Therefore, P/E analysis will have to wait until late this year, when some reasonable basis for 1993 earning projections develops.

In the interim, investors will be satisfied to know that they are buying a sustainable dividend and real book value. The average bank stock will move back toward a yield more in-line with the overall market. Today, the S&P 400 yields 2.9% on its current dividend of $13.10. The ten multinational banks we follow have an average yield of 6.2%, and the yield of the 31 regionals we follow averages 4.3% (excluding the five banks which have already eliminated their dividends, the group yields 5.2%).

Individual bank yields at the end of this year should be highly correlated to perceptions about the sustainability of their dividends. Any banks with high dividend payout ratios will pique investor concerns and would therefore continue to require a high dividend yield.

While bank regulators are likely to be far less stringent in their oversight this year, we do not believe that they will relax rules for paying dividends. Put simply: If banks don't earn it, they can't pay it out. Under this assumption, our stress-test causes us to believe that there will be another round of dividends cuts and possible a few eliminations this year. It is likely that dividends will be reduced at: Chase Manhattan, Citicorp, Manufacturers Hanover, Security Pacific, Barnett Banks, C&S/Sovran, First Interstate, and PNC Financial. Dividends may be eliminated at Bank of Boston, Fleet/Norstar Financial, and Signet Banking. Projected year-end dividends for each of the banks we follow are shown in Table 4.

The table also shows the current annual dividend rates, as well as our best estimates of dividend payout ratios as a result of our stress-tests. The last column in this table also details our estimates of reasonable target dividend yields. Our estimates are clearly related to the safety of those dividends. Banks with very high dividend payouts, such as First Chicago (81.7%) and Meridian (89.0%), will likely concern investors. The yield required to compensate investors for the risk of a dividend cut may remain high. We have projected year-end yields of 8.0% and 7.5% for these two banks, respectively. Conversely, banks, such as State Street Boston (with a payout of only 24.0%), BankAmerica (24.5%), and Norwest (34.0%), with good dividend coverage will probably fall to yields in the 1.5%-3.0% range.

Table 4

ESTIMATED DIVIDENDS PER SHARE, PAYOUT RATIOS AND YIELDS

	Ticker Symbol	Price 3/6/91	Dividend			Dividend Payout Ratio		Dividend Yield	
			Current	Estimated Yearend	Percent Change	1991E	1992E	Current	Estimated Yearend
Multinational Banks									
BankAmerica Corp.	BAC	$34.13	$1.20	$1.20	0.0 %	24.5 %	27.3 %	3.5 %	3.0 %
Bank of Boston Corporation	BKB	8.00	0.40	0.00	-100.0	-2.9	0.0	5.0	0.0
Bankers Trust New York Corp.	BT	46.25	2.54	2.36	-0.8	54.6	48.8	5.5	4.8
Chase Manhattan Corp.	CMB	15.25	1.20	0.80	-33.3	63.2	48.9	7.9	6.8
Chemical Banking Corp.	CHL	18.00	1.00	1.00	0.0	60.2	54.0	5.6	7.3
Citicorp	CCI	15.75	1.00	0.40	-60.0	77.4	34.6	6.3	6.0
First Chicago Corp.	FNB	24.63	2.00	2.00	0.0	81.7	77.5	8.1	7.5
Manufacturers Hanover Corp.	MHC	26.50	1.80	1.00	-44.8	62.6	35.1	7.1	5.8
J.P. Morgan & Co., Inc.	JPM	45.13	1.98	2.14	8.1	52.8	49.8	4.4	3.5
Security Pacific Corp.	SPC	28.50	2.52	1.00	-60.3	78.7	57.2	8.8	6.0
Regional Banks									
Banc One Corporation	ONE	35.00	$1.16	1.16	0.0	50.0	42.0	3.3	2.8
Barnett Banks, Inc.	BBI	24.88	1.32	0.60	-54.5	191.0	37.0	5.3	4.0
CBT/Conran	CYN	20.38	1.56	1.00	-35.9	74.0	43.0	7.7	4.8
CoreStates Financial Corp.	CSFN	35.63	1.92	1.92	0.0	70.0	51.0	5.4	5.5
First Bank System, Inc.	FBS	17.50	0.82	0.82	0.0	44.0	37.0	4.7	3.5
First Fidelity Bancorporation	FFB	23.88	1.20	1.20	0.0	37.0	32.0	5.0	3.8
First Interstate Bancorp	I	35.88	3.80	1.40	-53.3	54.9	28.8	8.6	3.8
First Union Corporation	FTU	20.75	1.08	1.12	3.7	70.0	49.0	5.2	5.3
First Wachovia Corp.	FW	48.88	1.68	1.68	0.0	41.0	40.0	3.4	3.0
Firstar Corporation	FBR	30.75	1.32	1.40	6.1	39.0	34.0	4.3	3.3
Fleet/Norstar Financial	FNG	15.88	0.80	0.00	-100.0	-62.0	0.0	5.0	0.0
KeyCorp	KEY	28.88	1.36	1.36	0.0	62.0	36.0	4.7	3.8
Mark Twain Bancshares, Inc.	MTWN	16.25	0.88	0.88	0.0	44.0	35.0	5.4	4.3
Mellon Bank Corp.	MEL	25.88	1.40	1.40	0.0	72.0	61.0	5.4	6.0
Meridian Bancorp	MRDN	16.13	1.20	1.20	0.0	89.0	61.0	7.4	6.8
Midlantic Corporation	MIDL	7.50	0.00	0.00	NM	0.0	0.0	0.0	0.0
MNC Financial	MNC	4.38	0.00	0.00	NM	0.0	0.0	0.0	0.0
National City Corp.	NCC	37.25	1.88	1.96	4.3	80.0	54.0	5.0	5.0
NBD Bancorp	NBD	36.00	1.60	1.60	0.0	61.0	37.0	3.7	3.0
NCNB Corporation	NCB	31.38	1.48	1.48	0.0	54.0	44.0	4.7	4.8
Norwest Corporation	NOB	25.38	0.92	0.92	0.0	34.0	31.0	3.6	3.0
PNC Financial Corp.	PNC	30.25	2.12	0.80	-62.3	75.0	35.0	7.0	4.0
Shawmut National	SHC	7.00	0.00	0.00	NM	0.0	0.0	0.0	0.0
Signet Banking Corp.	SBK	14.63	1.56	0.00	-100.0	101.0	0.0	10.7	0.0
Society Corp.	SOCI	37.50	1.76	1.84	4.5	43.3	41.5	4.7	3.5
Southeast Banking Corp.	STB	6.75	0.00	0.00	NM	0.0	0.0	0.0	0.0
SunTrust Banks, Inc.	STI	26.13	0.92	0.92	0.0	54.0	40.0	3.5	4.3
State Street Boston	STBK	42.00	0.68	0.76	11.8	24.0	22.0	1.6	1.8
U.S. Bancorp	USBC	27.13	1.00	1.00	0.0	54.0	44.0	3.7	3.8
Valley National Corp.	VNCP	19.63	0.00	0.00	NM	0.0	0.0	0.0	0.0
Wells Fargo & Co.	WFC	79.38	4.00	4.00	0.0	41.5	31.5	5.0	4.5
Multinational bank average					-29.2	56.2	42.5	6.2	5.1
Regional bank average					-12.1	47.0	31.2	4.3	3.2
40-bank average					-16.3	49.3	34.0	4.8	3.6

Source: C.J. Lawrence estimates.

Just as investors' confidence on the sustainability of dividends returns, they will also be willing to pay for "real" book value. Last year, all banks' book values were suspect. This year, investors will begin to be able to differentiate between those banks that face continued losses and those whose trough earnings allow for some growth in book value. The brighter the prospects, the greater the premium an investor will accord on a price-to-book basis. A bank with a strong capital ratio, good reserve coverage, and healthy prospective return on equity (ROE) will be perceived as a leading candidate for market share gains and will therefore be accorded a large premium to book value.

Table 5 shows our estimates of year-end nonperforming asset ratios, reserve coverage ratios, fourth quarter equity-to-assets ratios, and return on equity projections for 1991 and 1992. Also shown are our year-end target price-to-book ratios. Our estimates of price-to-book reflect each of the other variables shown. Our highest projected price-to-book ratio was accorded to Banc One. We expect equity-to-assets to remain at 10% late this year. On that exceptional equity we are forecasting a 15.1% ROE in 1992. Under our stress-test, nonperformers will peak at 3.6% with a reserve coverage ratio of 50% at year-end 1991. With that quality balance sheet and earnings power, Banc One's prospects are among the best in the industry. We suspect that investors will be willing to pay over twice book value for such a bank.

Alternatively, there are banks whose book value will continue to be suspect because of ongoing operating losses. These will continue to sell at deep discounts to the reported book values. Bank of Boston, Shawmut National, MNC Financial, Southeast Banking, and Midlantic, all fall into this category. The rest of the banks in our universe fall somewhere in between. The last column in this table shows our forecasts for target year-end price-to-book ratios.

In Table 6 we apply our targets for yield and price-to-book to our estimates of dividend and book value derived from our stress-tests. We average the target prices arrived at by both sets of statistics to calculate our target price. In this table, we have ranked the banks in the order of the greatest upside potential from current prices.

Firstar Corporation, a Wisconsin bank holding company, ranks the highest. This is one of the few banks we feel comfortable projecting a dividend increase for this year. Even under our stress-test returns on equity will likely exceed 12.0% this year and 13.5% next year. Equity-to-assets should end the year at a healthy 7.7%, and nonperformers under our assumptions will peak at 3.4%, with a reserve coverage of 73%. At a 3.3% yield target and 150% of book value the shares would sell at $43 or 39% above the current market price.

Society Corporation, an Ohio bank, also passes our stress-test with flying colors. Nonperformers should peak at 3.3%, with 59% reserve coverage. Equity-to-assets should end the year at 6.9%. On this equity it is likely Society Corp. can earn 13.5% both this year and next. At a 3.5% yield and 155% of book value, the shares would trade at $52, 38.5% above the current levels.

The smallest bank we follow, Mark Twain Bancshares, ranks the third highest. Even at modest valuations on both a yield and price-to-book basis, our target price approaches $22, a 34.7% gain from its current $16.25. Total return with its current yield of 5.4% is about 40%.

We are upgrading Firstar Corporation, Society Corporation, Mark Twain, and NBD Bancorp. Further, we are also reinstating our purchase recommendation of First Fidelity. Under this analysis, it appears that an appropriate price target is $31-$32, 33% above current levels.

Table 5
PROJECTED CREDIT QUALITY, RESERVES, CAPITAL RATIOS, ROEs AND TARGET PRICE-TO-BOOK RATIOS

	Projected Yearend 1991 Nonperforming Asset Ratios		Estimated Yearend 1991 Reserve-to-Non-LDC Nonperforming Assets	Estimated 4th Qtr 1991 Equity-to-Asset Ratio	Return on Equity Estimates		Target Price-to-Book
	Total	Non-LDC			1991	1992	
Multinational Banks							
BankAmerica Corp.	4.37 %	2.88 %	69.5 %	6.1 %	15.4 %	15.2 %	150 %
Bank of Boston Corporation	10.41	10.30	44.0	3.6	(37.0)	(27.3)	35
Bankers Trust New York Corp.	15.63	12.39	37.5	5.2	12.2	13.4	145
Chase Manhattan Corp.	9.40	8.02	37.5	4.9	4.8	5.6	70
Chemical Banking Corp.	10.58	9.78	33.5	5.3	5.4	6.3	70
Citicorp	9.41	7.92	20.0	5.0	5.3	5.5	80
First Chicago Corp.	7.72	7.18	40.4	4.8	5.7	6.0	80
Manufacturers Hanover Corp.	12.57	8.67	29.6	5.4	4.8	5.8	90
J.P. Morgan & Co., Inc.	2.61	1.97	75.0	5.3	13.1	14.1	185
Security Pacific Corp.	6.74	6.66	36.8	5.4	4.6	4.7	85
Regional Banks							
Banc One Corporation	3.56	3.56	50.0	10.0	12.4	15.1	220
Barnett Banks, Inc.	5.55	5.55	45.0	5.1	2.0	6.4	75
CS&S/Sovran	3.61	3.61	70.0	6.1	6.8	9.9	125
CoreStates Financial Corp.	4.07	4.07	65.0	6.0	10.7	14.3	145
First Bank System, Inc.	3.53	3.53	70.0	6.0	13.3	15.7	160
First Fidelity Bancorporation	6.74	6.74	56.0	4.8	14.2	15.2	130
First Interstate Bancorp	6.50	6.51	36.8	6.0	8.6	10.3	110
First Union Corporation	5.07	5.07	50.0	6.3	6.7	10.4	115
First Wachovia Corp.	1.49	1.49	81.0	8.1	14.3	15.2	210
Firstar Corporation	3.40	3.40	73.0	7.7	12.2	13.6	150
Fleet/Norstar Financial	11.08	11.08	41.0	5.5	(3.9)	2.4	60
KeyCorp	2.33	2.33	55.0	5.6	12.6	14.3	145
Mark Twain Bancshares, Inc.	3.22	3.22	50.0	5.9	13.6	15.6	135
Mellon Bank Corp.	6.82	6.82	41.0	4.3	10.0	12.1	100
Meridian Bancorp	3.23	3.23	62.0	5.8	7.5	10.9	105
Midlantic Corporation	12.61	12.61	44.0	4.9	(12.6)	(8.3)	25
MNC Financial	23.89	23.89	39.0	4.9	(56.5)	(101.7)	25
National City Corp.	3.65	3.65	49.0	6.9	9.1	13.1	155
NBD Bancorp	1.90	1.90	85.0	7.4	13.1	14.4	185
NCNB Corporation	3.67	3.67	53.0	4.7	8.8	10.6	120
Norwest Corporation	2.47	2.47	93.0	6.1	18.2	19.4	190
PNC Financial Corp.	6.03	6.03	50.0	5.6	5.1	7.6	85
Shawmut National	17.93	17.93	50.0	3.8	(34.2)	(39.8)	35
Signet Banking Corp.	6.88	6.88	50.0	5.8	1.1	3.8	60
Society Corp.	3.32	3.32	90.0	6.9	13.5	13.6	155
Southeast Banking Corp.	9.62	9.62	30.0	3.5	(26.8)	(26.4)	35
SunTrust Banks, Inc.	4.49	4.49	50.0	7.3	9.2	12.0	145
State Street Boston	5.95	5.95	50.0	6.7	16.0	17.4	210
U.S. Bancorp	4.01	4.01	50.0	6.7	9.1	11.9	145
Valley National Corp.	7.24	7.24	32.0	4.5	(0.5)	3.5	50
Wells Fargo & Co.	4.81	4.81	50.0	6.5	14.1	18.7	175
Multinational bank average	8.94	7.58	42.6	5.1	3.0	4.5	99
Regional bank average	6.08	6.08	56.7	6.0	6.3	6.9	121
40-bank average	6.78	6.45	51.7	5.8	6.0	6.8	116

Source: C.J. Lawrence estimates

Table 6

TARGET PRICES AND 1992 PRICE/EARNINGS MULTIPLES
(ranked by percentage gain from current prices)

	Target Dividend Yield	Target Price-to-Book	Target Price Based on Terminal: Dividend Yield	Price-to-Book	Average	Percentage Gain from Current Price	1992 Earnings Per share Estimate	Target Price/'92 EPS
Firstar Corporation	3.3 %	190 %	843.08	842.68	842.88	39.4 %	$4.30	10.0 x
Society Corp.	3.5	155	32.57	31.29	31.93	38.5	4.65	11.2
Mark Twain Bancshares, Inc.	4.3	135	20.71	23.09	21.90	34.7	2.90	8.8
First Fidelity Bancorporation	3.8	130	32.80	31.55	31.78	33.1	3.75	8.5
First Bank System, Inc.	3.5	160	23.43	22.96	23.19	32.9	2.35	9.9
KeyCorp	3.8	143	36.27	39.00	37.68	30.5	4.00	9.4
NBD Bancorp	3.0	185	46.67	50.88	48.77	28.3	4.00	12.2
BankAmerica Corp.	3.0	150	40.00	46.59	43.30	26.9	5.50	7.9
Wells Fargo & Co.	4.5	175	88.89	110.41	99.65	25.5	13.95	7.1
Norwest Corporation	3.0	190	30.67	32.05	31.36	23.6	3.25	9.6
J.P. Morgan & Co., Inc.	3.5	185	41.14	50.06	55.60	23.2	4.30	12.9
First Wachovia Corp.	3.0	210	56.00	63.11	59.55	21.8	4.65	12.8
C&S/Sovran	4.8	125	21.05	27.79	24.42	19.9	2.30	10.6
Banc One Corporation	2.8	220	41.43	42.35	41.89	19.7	3.00	14.0
First Interstate Bancorp	3.8	110	37.33	45.74	41.54	15.8	4.85	8.6
First Chicago Corp.	7.5	80	26.67	29.38	28.02	13.8	2.50	10.9
Signet Banking Corp.	0.0	60	NM	16.60	16.60	13.5	1.05	15.8
Meridian Bancorp	6.8	105	17.78	17.87	17.82	10.5	1.95	9.1
First Union Corporation	5.3	115	21.33	24.38	22.86	10.2	2.50	9.1
Bankers Trust New York Corp.	4.8	145	53.89	47.57	50.73	9.7	5.20	9.8
National City Corp.	5.0	155	39.20	42.27	40.73	9.4	3.60	11.3
Chase Manhattan Corp.	6.8	70	11.85	21.13	16.49	8.1	1.95	8.5
NCNB Corporation	4.8	120	31.16	36.02	33.59	7.0	3.50	9.6
SunTrust Banks, Inc.	4.3	145	21.65	33.90	27.77	6.3	2.30	12.1
State Street Boston	1.8	210	43.43	44.90	44.16	5.2	3.75	11.8
U.S. Bancorp	3.8	145	26.67	29.99	28.33	4.4	2.50	11.3
Chemical Banking Corp.	7.3	70	13.79	23.37	18.58	3.2	1.85	10.0
CoreStates Financial Corp.	5.5	145	34.91	38.03	36.47	2.4	3.80	9.6
Nation Bank Corp.	6.0	100	23.33	29.06	26.20	1.2	2.40	10.9
Manufacturers Hanover Corp.	5.8	90	17.39	35.82	26.61	0.4	2.85	9.3
Midlantic Corporation	0.0	25	NM	7.09	7.09	-5.5	(2.20)	NM
Citicorp	6.0	80	6.67	20.60	13.63	-13.4	1.15	11.9
Security Pacific Corp.	6.0	85	16.67	28.15	22.41	-21.4	1.75	12.8
PNC Financial Corp.	4.0	85	20.00	23.10	21.55	-28.8	2.25	9.6
Barnett Banks, Inc.	4.0	75	15.00	19.85	17.43	-29.9	1.60	10.9
Southeast Banking Corp.	0.0	35	NM	4.66	4.66	-31.3	(2.80)	NM
NMC Financial	0.0	25	NM	2.86	2.86	-34.6	(7.70)	NM
Valley National Corp.	0.0	50	NM	11.46	11.46	-41.6	0.80	14.3
Shawmut National	0.0	35	NM	3.85	3.85	-45.1	(3.60)	NM
Bank of Boston Corporation	0.0	35	NM	4.39	4.39	-45.2	(3.65)	NM
Fleet/Norstar Financial	0.0	40	NM	6.66	6.66	-58.2	0.60	11.1

Source: C.J. Lawrence estimates

We also reaffirm our purchase recommendations on KeyCorp, BankAmerica, and First Bank System, which rank extremely well with this valuation model.

This analysis leads us to downgrade PNC Financial (from HOLD to AVOID) where a potential dividend reduction will likely erode any valuation floor. In this analysis the bank has a greater than 25% downside risk.

We also see no reason to upgrade our current SELL recommendations, which remain: Bank of Boston, Chase Manhattan, Citicorp, Manufacturers Hanover, Barnett Banks, Fleet/Norstar Financial, MNC Financial, Shawmut National, and Southeast Banking; nor our AVOID rating for Valley National.

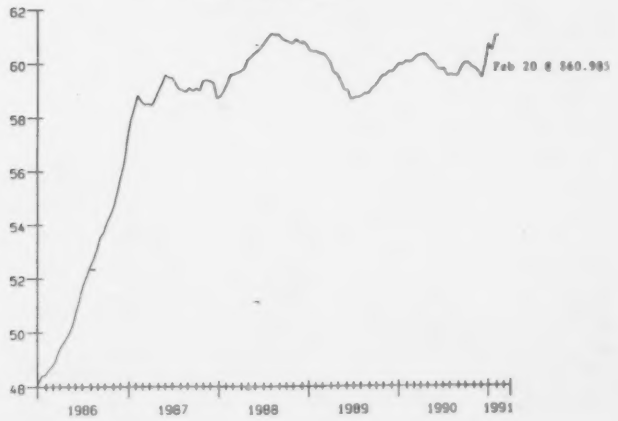
Lingering Fears

The markets, both bond and stock, appear to be telling us that Fed easing will bring about an economic recovery over the next few months. We hope so. But we are not thoroughly convinced. We believe that the Fed followed rates down during 1990. It was the lack of demand for credit that allowed rates to fall and not Fed easing. Even after the reduction in reserve requirements and two discount rate cuts, it does not appear that the Fed is pumping significant new liquidity into the system.

Total reserves have increased only 2% (see Figure 10). Prior to the recovery in 1983, reserves increased 10%. Moreover, the total increase in reserves has been in excess reserves. When the increase comes in excess reserves, it means banks are not reintermediating the funds. They are not investing or lending; therefore, it has no stimulative effect on the economy.

Figure 10

TOTAL RESERVES
(8 week average)

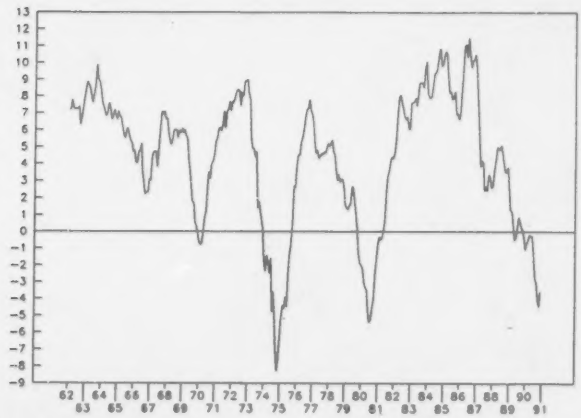


Source: Federal Reserve Board of Governors.

Liquidity in the system remains tight. The last data we have for real M4 growth remained decidedly negative at -3.6% in December (see Figure 11). This lack of liquidity concerns us. When the Fed is not creating "new" money in real terms, every new investment requires that capital be drained from another asset. Whatever asset you take capital away from is, by definition, deflating. It is this macroeconomic factor that is creating the problem credit cycle for banks. Credit problems will not begin to abate until "new" money is created in real terms.

Figure 11

REAL M4 GROWTH, 1962 – 1990



Source: Federal Reserve Board of Governors
U.S. Bureau of Labor Statistics.

Our lingering concern remains: Has the Fed really eased enough? The markets are saying: "Yes." Maybe it is just the natural cynicism analysts develop over the years, but we are not thoroughly convinced.

If our fears are realized, the Fed will likely ease more and eventually jump-start the economy. However, it would also mean that our stress-tests are probably not stringent enough and the earnings recovery for this industry is further away. As we see it, that is the risk to our investment thesis.

For now we choose not to bet against the markets. But we will closely watch the Fed and be prepared to change our investment recommendations if the economy doesn't pick up in the coming months.

Carole Berger
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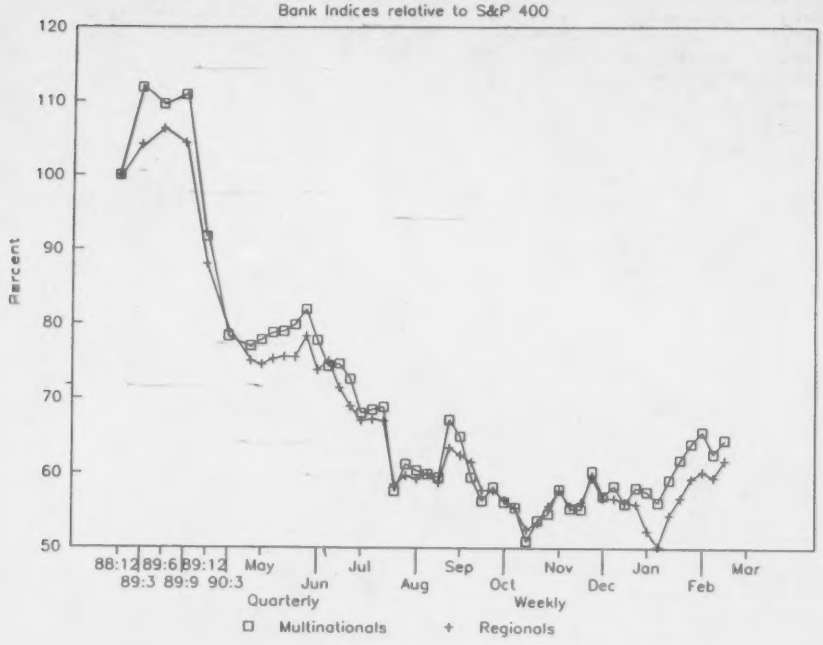
Copies of any or all of our stress-tested earnings estimate models are available upon request.

Appendix I

Relative Price Performance, 1989–91



Source: Company reports and C.J. Lawrence Inc. estimates.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
WILLIAM WEIANT

Dillon, Read & Co. Inc.

535 Madison Avenue
New York, New York 10022
212-906-7000

April 11, 1991

Ms. Lory Breneman
United States Senate
Committee on Banking,
Housing and Urban Affairs
Washington, D.C. 20510-6075

Dear Lory:

Please find enclosed my "answers" in response to your letter of March 5th. I apologize for the delay.

If you have any questions, please feel free to call me at 212-906-7595.

Sincerely,

William M Weiant

William M. Weiant
Managing Director

Dillon, Read & Co. Inc.

William M. Weiant

Q.1. Recently bank securities prices have reversed part of last year's sharp declines. Is that a just correction, or have bank prospects improved, and if so, why?

A.1. The recent improvement in bank stock prices from the lows of October/November are both a correction from overly depressed valuations and an improvement in bank prospects. The lows of the market reflected investors concern that the financial system was not going to survive. The increase in bank stock prices since that time has been about 50% reflecting in large part actions taken by the Federal Reserve to instill confidence in the overall financial system and steps taken by the regulatory agencies to alleviate a potential credit crunch. While the general economic environment has improved, there are still lingering bank problems such as real estate, which will take a number of years to work out.

Q.2. The Fed has lowered its interest rate targets 2 percentage points since last summer, but most banks have lowered their prime rate only half as much. Why has the prime been held up?

A.2. The prime rate has declined less than the cost of funds reflecting the normal interest rate cycle and the need to improve bank profitability. In the typical interest rate cycle the prime rate lags upward and downward changes in short term interest rates. In a declining interest rate environment banks reduce the prime rate in smaller increments than the reduction in short term interest rates as reflected by the federal funds rate. This is because only a portion of a bank's interest bearing liabilities are tied directly to short term interest rates while a relatively large portion of loans are tied in some way to the prime rate. For example, the bulk of bank deposit growth in recent years has been in consumer deposits which typically have fixed maturities for periods of three months to one year. As a result the overall cost of money for a bank tends to refect declines in interest rates relatively slowly. In addition money center banks have been trying to restore profitability by maintaining net interest income. In a period in which alternative sources of funds are less readily available for many corporate customers, it is only logical that banks would maintain firmer pricing than they would have in recent years.

Q.3. Do you think the industry's large loan losses and high failure rate are temporary problems that will end after a year or two, or are they likely to continue over a longer period?

A.3. The rate of increase in non-performing loans should slow in 1991 from the pace of 1990 but the absolute levels of non-performing loans are not likely to peak until sometime in 1992. The negative earnings impact of a high level of non-performing loans will continue well beyond 1992. Based on the experiences of banks in the 1970s, real estate problems, which are the principal area of concern at the momemt, are cured over a long period. Bank earnings are likely to remain depressed because of the loss of net interest income, the expense of operating foreclosed real estate, and a higher than normal level of provisions for loan losses. The failure rate for banks should decline after 1992 but it is likely to remain at much higher than historic levels for a number of years.

Dillon, Read & Co. Inc.

William W. Weiant

Q.4. Comptroller General Bowsher of the GAO wrote to me earlier this month regarding his concerns about the Bank Insurance Fund and added, "we have evidence that the banks lack effective controls over their operations and that accounting is masking their true condition." Do you share his concerns?

A.4. Comptroller General Bowsher's view is difficult to deal with. The statement that accounting is masking the banks true condition is not accurate. The problem is simply that economic conditions especially in real estate have been deteriorating so rapidly that it has caused errosion in asset values that are larger amounts than anyone expected. I do not think there is any evidence that banks are more lacking in controls than are other industries. The problem is that banking is a highly leverage industry so that small errors in estimating problems such as loan losses has a disproportionate impact on net income and on capital.

Q.5a The new regulatory guidelines issued March 1 encouraged greated disclosure of information regarding nonperforming loans. How helpful do you think you would find such information?

A.5a The new guidelines proposed by the regulators on non-performing loans would be helpful in evaluating non-performing loans. At the moment it is difficult to determine how much loss there might be in the non-performing portfolios and the classifications proposed would shed some light.

Q.5b They also prescribe valuing collateral not at liquidation value, but rather using estimates of future rents. Is that a good idea or does it risk becoming a way of deferring the bad news?

A.5b Real estate should not be valued at liquidation. However, estimates of future values based on estimated rents, occupancy and discount rates, have to be done realistically. In my view most appraisals are not being done at liquidation value if the lending institution has good documentation concerning the borrower and the individual project.

Q.6. What will be the effects of higher deposit insurance premiums? How much can the industry afford?

A.6. Higher deposit insurance premiums will make the banks less effective competitors versus the institutions which are not burdened by these premiums. It is difficult to estimate how much the industry can afford but in my view further increases in deposit insurance premiums can be born by the industry without having negative long-term effects. However, higher insurance premiums must be accompanied by restrictions on brokered deposits and money market funds which, have taken advantage of deposit insurance.

Q.7. How much could costs be cut by mergers of large banks in the same market area?

A.7. While there is no factual evidence, the general feeling is that a merger of banks in the same market can reduce expenses of the combined institution by an amount equal to 30% of the non-interest expenses of the acquiroree.

Q.8. How helpful would full market value accounting or increased market value disclosures for banks be?

A.8. Market value accounting is not desirable and should be discouraged because it only marks select assets in most cases, to market and does not properly adjust the value of liabilities. Instead banks should be encouraged to make disclosure concerning the market value of investment securities and other assets which might have impaired value.

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